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OPINION

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Where Do We Draw the Line?

A direct bailout for automakers is inappropriate, and a pre-packaged bankruptcy featuring Treasury DIP financing will work

General Motors, which reported a $2.5 billion quarterly loss last Friday, has warned it could run short of cash by late December. And while Ford is in better shape, it, too, is having difficulty weathering the worst sales slump in 25 years. We assume that Chrysler, while a private company, is facing the same challenges. Expect lawmakers to address industry bailouts when they resume session next week.

We strongly recommend that troubled automakers be cleansed through prepackaged Chapter 11 bankruptcies, through which the Treasury agrees to provide debtor-in-possession ("DIP") financing to corporations undergoing the bankruptcy process. DIP lenders are senior to all unsecured creditors and hence take little credit exposure. But Treasury could provide needed funds for the automakers to continue operations under the aegis of the bankruptcy court in an orderly manner that preserves jobs. As a DIP lender, Treasury would have significant say in the bankruptcy process.

While many believe domestic automakers are too big to fail, it is important to understand that a Chapter 11 would not spell their demise. Rather, a filing would give manufacturers time to restructure their debts, restructure UAW agreements, and mitigate other legacy and contractual issues that hamstring them. Through bankruptcy, an automaker could close unprofitable operations, streamline without facing huge severance payments, and remove its uncompetitive corporate structure and weak management.

An automaker failure is different that of a financial institution. The latter provides the capital that allows our economy to operate. Hiccups in the banking system can create massive economic disruptions, while the loss of an automaker would stress our system through direct job losses, which are massively exaggerated in the press. An automaker's bankruptcy filing would most likely be in Chapter 11, which means the corporation would continue operations, most likely at current staffing levels (especially if Treasury was the DIP lender). These jobs may inevitably be lost, regardless of whether an automaker files for Chapter 11.

While it is true that a bankruptcy may create cash flow issues for trade creditors, this issue could be addressed either in first-day orders or through a purchase program, whereby Treasury buys trade credit from troubled suppliers.

Paramount in any restructuring is mitigating job losses—and unemployment is the only compelling reason we see for offering government assistance. The economy is too vulnerable at this juncture to be stressed by layoffs.

The best way to ensure stable employment for autoworkers is to create a profitable environment in which to work. The Big Three will not be globally competitive or profitable until and unless they control costs, slash debt burdens, build more appropriate products, address excess capacity and improve management. Such changes can be achieved only in a Chapter 11 bankruptcy.

Many companies have gone through Chapter 11, including Chrysler and Navistar. While car companies state such filings would slow sales to a trickle, they have a vested interest in disseminating such information to preserve shareholder value. Experts disagree. Automotive Lease Guide has estimated that a filing would reduce the value of GM's cars by only 4%. This makes sense. Much of the risk is already "baked into" current Big Three sales, and a public relations campaign could drastically diminish the sales effects of a filing. Further, if Treasury was involved in the filing—which could be part of a prepackaged plan—consumers should be assured the car maker will emerge a rejuvenated entity. Let's face it, if consumers will risk their lives flying on a bankrupt airline, they certainly will buy a car from a bankrupt automaker on government assistance. As a further step, reserves could be established to ensure that warranty obligations are met.

Some will argue that carmakers are essential to our national security. Perhaps so. But do we need all three of them? Again, the bankruptcy process would most likely create a stronger company.

And a Chapter 11 filing for any of the Big Three would make a more attractive acquisition. Detroit is hamstrung with legacy and labor agreements.

In a bankruptcy, plants that cannot be operated successfully would be closed or sold. "Rightsizing" could occur without massive severance expenses. Unproductive union contracts like the "jobs bank" program, which requires automakers to pay workers not to work, could be renegotiated. When automakers close unproductive plants or divisions, they must continue to pay workers, many of whom are no longer productively engaged. One of the few ways for Detroit to expunge these silly agreements is to file bankruptcy.

Some U.S. manufacturers, such as Boeing and Caterpillar, thrive in global competition, yet car companies founder. Legacy issues, poor management and contractual agreements hamstring automakers, and they cannot buy labor in a competitive market. All of these issues can be efficiently addressed in bankruptcy. A bailout tied to an agreement to produce environmentally friendly vehicles will compound problems and leave automakers with the status quo that's destroying them. While we are in favor of fuel-

efficient, environmentally friendly cars, tying survival aid to this objective is misdirected policy and will no doubt lead to further inefficiencies. Without fixing core issues, government assistance will merely be a down payment toward another bailout in the future. Let's fix the problem once and for all.

So, who loses in a prepackaged bankruptcy where the government acts as a DIP lender?

Unions lose. Outside of bankruptcy, unions have little incentive to renegotiate onerous contracts. While Treasury's goal should be to preserve jobs, it should strive to accomplish this in a way that minimizes taxpayer cost. Because equity ownership could be bargained for inappropriate contract clauses, a stronger, employee-owned company could emerge from bankruptcy. And rather than being granted "jobs bank" employment, displaced workers should be offered infrastructure jobs or other productive work. It may be necessary to provide assistance to areas affected by massive layoffs, and money should be made available to re-train workers.

Shareholders and some unsecured creditors lose. Shareholders will most likely see their holdings wiped out in a bankruptcy. But these holdings have little, if any, value now (the main value may be the hope of a non-bankruptcy bailout). Through motions and other rights they have in bankruptcy, unsecured creditors will likely fare better than shareholders, but in this instance may share a similar fate. If automakers are allowed to continue with government assistance, we will effectively see a transfer of wealth from taxpayers to unsecured and equity holders—not fair or necessary.

Current management loses. An effective management team would be put in place to resume operations. Executive compensation will be reasonable, and there will be no golden parachutes. We have little sympathy here; these are the guys who got us into this mess.

The big winners will be employees and taxpayers. Retained employees will work for a company that has a shot at being successful, unburdened by legacy and ready to produce cars the market wants. Displaced workers will be given jobs wherein they can be productive or retrained. Employees will be the owners of the companies for which they work.

And taxpayers win big. There is no reason the United States can't produce great cars. But we have no chance of doing so unless we fix the industry—and the only way to do this is to cleanse it completely. Any other solution is merely a costly Band-Aid. The only compelling reason we can see for a non-bankruptcy bailout is to postpone the inevitable until the economy is less fragile. By doing so, concerns for suppliers, employees and communities (as discussed above) would be mitigated.

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