

The Case for Bankruptcy in the Automotive Industry

Containing Damage, Protecting Workers, and Ensuring Economic Stability

While Congress and the administrations – both current and future – compare the risks of automotive failure with the loss of the moral hazard for poorly run companies, they have overlooked a simple yet effective way forward. This paper outlines the method that the Federal Government should choose to protect the markets while shielding the American people from a catastrophic free-fall bankruptcy by one of the former Big Three.

Key Summary Points

1. The loss from the failure of one or more of the Detroit Three automotive manufacturers has been understated. While others have offered insight into direct and indirect job loss, little research has been completed to explain the impact on bond markets, pension funds, and other institutional investors.
2. Existing options do not provide an effective option to remedy the current crisis facing the Detroit Three. Both the “too big to fail” and “moral hazard” schools of thought all but guarantee increased governmental involvement, reduced employment, and further loss of confidence in our financial system.
3. An effective response to the situation should lead to a healthy American economy as it shields the broader markets from the failure while at the same time creating a sustainable future for the Detroit Three. It should also utilize only existing legal mechanisms, stabilize the middle class consumer, and offer a proven means to tactical implementation.
4. Prepackaged bankruptcy is the only means of containing the current crisis while ensuring a high likelihood of tactical implementation. By utilizing existing market mechanisms, the Federal Reserve can provide the liquidity necessary for Debtor in Possession (DIP) financing to the failed entity, through a qualified bank, at a level consistent with current supply and payables obligations.
5. An appropriate prepackaged bankruptcy will ensure DIP financing commensurate to current outstanding obligations in exchange for government input on minimum wage and benefit levels of future automotive employees. It will also provide protections for the DIP lender while limiting Congressional input to that of oversight of the Federal Reserve.
6. Once in place, a government negotiated prepackaged bankruptcy can continue through traditional channels, limiting both further risk on the part of taxpayers as well as ongoing governmental involvement in free markets.

Key Questions for Executives

- Would this proposal safeguard your company from a cascade of bankruptcies?
- Given full payment for outstanding obligations from your automotive customers, could you rebuild your business to reflect the new market realities of a bankrupt OEM?
- How can you influence your Governor and Representatives to implement this approach?

The Stage is Set

Detroit has come back to Washington. And this time things are different. They aren't lobbying against the kind of performance that their international competitors have achieved without governmental prompting. They are instead begging for their lives. Forget our management failures, they ask: quality, design, marketing, and cost structure are all important, and yes, we did in fact neglect all of these. But, they argue, if we go, think of the swath of destruction we'll leave in our wake.

At the same time eager members of the United Auto Workers have suggested that not only was it hubris to fly to Washington in a company jet, but that upon their return to the capitol next week these executives should drive instead. Different television news networks offer slightly modified versions of blame. Some suggest that labor is to blame, others senior management, still others unfair international competition.

In Washington the debate has centered on the impact of a freefall bankruptcy by one of these manufacturing behemoths. Many focus on the analysis by the Center for Automotive Research, projecting job loss of 2.5 million if the Detroit Three fall¹. This necessary and substantive discussion has produced two distinctly different schools of thought. One could be considered the "moral hazard" school of thought, while the other is the "too big to fail" school of thought. Both provide valid arguments, yet neither solves our current crisis.

The "moral hazard" school correctly identifies a significant risk: the bailout of a single auto manufacturer will prompt requests for additional bailouts from other weak firms and/or industries. It will also reward shareholders who have supported the management decisions in the previous years and decades that have led to the current condition of these companies. Let them fail, they say, and then pick up the pieces.

The "too big to fail" provides the counterpoint: the loss of a single automotive manufacturer will not only provide the immediate loss of jobs, the potential for cascading bankruptcies among auto suppliers, and further reduce consumer confidence on a global level, but it will also place additional stress on bond markets. Reinsurance firms cannot handle another major loss, while municipalities and other bondholders cannot shoulder the portfolio failure. If we let them go, says this school, we invite economic ruin.

While these two strategic directions seem mutually exclusive, there is a third way. This alternative blends the two strategic needs of these competing schools of thought, while providing a route which has foreseeable and therefore manageable tactical approaches.

Tactical Drawbacks of Existing Options

In examining the options which have been offered to date, we found that once the strategic direction had

been set, it was not feasible to foresee the tactical requirements needed for successful execution. The table below outlines the critical issues which could not be defined or planned for:

<u>“Too Big To Fail”</u>	<u>“Moral Hazard”</u>
<p>Cost</p> <ul style="list-style-type: none"> Limited controls once loans granted Little assurance that initial loan will be the only assistance needed 	<p>Cost</p> <ul style="list-style-type: none"> Complete loss of value for shareholders Minimized value for bondholders Partial to complete loss of receivables for suppliers
<p>Market Impact</p> <ul style="list-style-type: none"> Loss of moral hazard Other firms and industries can expect support Systemic governmental involvement in business Reduced confidence in financial system and markets 	<p>Market Impact</p> <ul style="list-style-type: none"> Cascading bankruptcies throughout automotive supply, regional banking, and commercial paper markets Initial slump in domestic automotive employment Increased unemployment rate due to automotive and non-automotive jobs loss
<p>Implementation</p> <ul style="list-style-type: none"> Governmental oversight required throughout New laws, precedent, and/or agencies must be created to manage implementation 	<p>Implementation</p> <ul style="list-style-type: none"> Extensive resource draw on bankruptcy courts resulting from significant increase in unplanned bankruptcies

The drawbacks of each approach can be clearly seen when examined in this manner. While fundamentally at odds, these two idealistically-based plans for a healthy automotive industry offer the same basic outcomes: increased stress on the domestic economy, workforce, and financial markets. They also essentially guarantee increased governmental involvement in the US economy, either as a consequence of new agencies and programs, or as a requirement in managing the dissolution and distribution of the assets held by now-defunct firms.

It is clear therefore that despite ideological differences, the two strategies offered hold a high likelihood of increased cost and unintended consequences. Regardless of the strategic approach chosen, tactical implementation seems a daunting task, one which will require additional governmental involvement in the markets.

Strategy Selection as a Function of Tactical Implementation

As the outcome of both of the existing choices leads to a substandard outcome, Simplicity Tactics has undertaken the development of a new approach.

This alternative provides a synthesis of the main outcomes advocated by both the “too big to fail” and the “moral hazard” schools of thought:

1. A healthy US economy resulting from the remedy to current crisis
2. Containment of economic fallout from de-facto failure at Detroit-based automotive manufacturers
3. A competitive domestic automotive industry

To these we added three requirements which would increase the odds of longer term success:

1. No additional regulation, governmental agencies, or statutes created to remedy current crisis
2. Stabilization and expansion of the American middle class as a result of remedy
3. Utilize a method which does not require ad-hoc decision making

A plan which encompasses all six objectives would not only provide an exit from the current crisis, but also build a baseline for future economic expansion by limiting government’s role in a more effective free market. However, the additional items place a further burden on creativity, and seem to broaden the gap between the two current approaches to problem solving.

Nonetheless, this gap is not only much easier to bridge than it appears, but the mechanism for doing so already exists. It ensures that the firms involved will have a more competitive cost structure while at the same time offering long term stabilization to the American middle class. It ensures a healthier US economy while it simultaneously prevents cascading failures at automotive suppliers, related industries, and the financial markets. And while the so-called “bailout” of financial firms navigates through uncharted waters, this proven method of implementation utilizes neutral third party oversight to guarantee tactical implementation.

Because this approach, a prepackaged bankruptcy, can satisfy all six of these key tactical outcomes and requirements, it is the only appropriate answer to the current crisis.

Not All Bankruptcies Are Created Equal

The particular benefit of the bankruptcy law for distressed firms is the ability to assume or reject existing contracts and agreements. In the case of the automakers, this means not only their current labor agreements, but supply agreements, cross-development and marketing agreements, and dealer network agreements. Through the bankruptcy proceedings, an existing automaker can emerge as unsaddled with past error as a startup firm – only with the distribution network, product lineup, and brand recognition of an established company.

The difference between a freefall and prepackaged bankruptcy is significant. While the freefall occurs suddenly and without the involvement of key financial suppliers and stakeholders, a prepackaged bankruptcy begins with the participation of many of these constituencies. Firms choosing a prepackaged bankruptcy can remain in control of their supply chains, marketing message, and public opinion.

Additionally, a freefall bankruptcy creates a combative situation where senior debt holders are at odds with unsecured creditors. It creates an unwinnable situation for organized labor, which again leads to increased combativeness and reduced viability for both firm and worker in the future. And as this approach by definition excludes outside involvement of policymakers, a freefall in the current market would introduce serious risk of ongoing and systemic business failure.

The first step in a bankruptcy is to obtain ongoing financing, also known as Debtor in Possession (DIP) financing. In the current market environment, obtaining DIP financing is more difficult than in the past. The lack of liquidity in the banking sector, partnered with a general risk aversion on the part of lenders, has created a scarcity of funding. Yet it is this scarcity which creates tremendous opportunity on the part of our policymakers. And it is with this step that our alternative plan begins.

Creating Stability Through Negotiated Requirements

Because the Detroit-based auto makers will be hard pressed to find DIP financing, the government has the opportunity to play a key role as a moderating force in the bankruptcy proceedings. Again, where a freefall bankruptcy creates significant market uncertainties, a government negotiated prepackaged bankruptcy can offer the broader economy a measure of comfort and stability. In exchange for the guarantee of adequate funding, an appropriate plan will contain key elements which balance the competing needs of lenders, suppliers, and employees.

A successful prepackaged bankruptcy for any of the Detroit Three should contain four elements for success. These elements, necessary for supporting the six key objectives listed above, are:

1. Direct Federal Reserve support for the DIP lender and bankrupt firm
2. Initial DIP financing to meet current outstanding obligations to trade vendors, warranty holders, and retirees
3. The requirement that labor agreements provide a wage and benefit floor comparable to other automotive manufacturers in the United States
4. No congressional participation in the ongoing bankruptcy proceedings and their resolution

The first element, direct support by the Federal Reserve, is intended to calm broader financial markets at the beginning of a prepackaged bankruptcy. An unintended consequence of any bank assuming the role of DIP lender to any of the automotive markets could be the immediate shorting of stocks of the lender. This could in turn lead to a run on the companies, driving away lenders and customers from the bank. Support from the Federal Reserve can be limited, but will need to include ongoing access to funding as well as a short term ban on short selling of the lenders' stock.

The injection of DIP financing equivalent to current outstanding trade obligations, vehicle warranty holders, and retirees is designed to satisfy two of the main objectives listed earlier – to contain the current crisis from

cascading through the financial and manufacturing sectors, while at the same time stabilizing the middle class.

This level of initial support will allow current suppliers to escape the bankruptcy whole. While this does not ensure these firms' ongoing viability, it does prevent a massive wave of bankruptcies from wiping out scores of mid-sized manufacturing firms and the local and regional banks supplying them. Once this has occurred, the firms would have the option to continue their relationship with the automotive manufacturer, and banks the option to continue lending them money.

An interesting characteristic of these two items is that by providing liquidity to one portion of the market, the Federal Reserve can create additional liquidity and lending in other segments. With the balance sheet risk of current automotive suppliers minimized, local and regional banks will have the opportunity to increase home and auto loans to consumers. By meeting existing pension and healthcare requirements to retirees, consumer confidence can improve, in turn increasing consumer demand. And because the DIP also backs existing warranties of vehicles manufactured by the failed auto firm, further uncertainty is mitigated. This means that these manufacturers' vehicles can retain much of their residual value, which should in turn support ongoing consumer demand for these brands.

While the government could choose to allow the prepackaged bankruptcy to occur without its involvement, participation allows the administration the opportunity to assist in negotiation between labor and management. Decades of lopsided labor agreements created an unsustainable cost basis for the Detroit Three. Yet the crisis at hand could lead to equally lopsided agreements favoring the automotive companies, which could in turn lead to decreased consumer demand, tax revenues, and ongoing government support for the industry.

By requiring a starting level of wages and benefits comparable to other domestic automotive manufacturers such as Toyota, Honda, Subaru, Mitsubishi, Hyundai and others, the risk of economic damage can be minimized or completely mitigated. This approach, effectively a restart button on labor agreements, also limits governmental involvement in the free market to ensuring that the manufacturing base provides a living wage.

Finally, the successful plan will use existing powers of the Federal Reserve, eliminating the involvement of Congress. While economists and social policy makers can debate the merits of regulation, few would disagree that the ongoing input of hundreds of legislators would unduly slow the process of reorganization. Nonetheless, Congressional control of the budgetary mechanisms allows for broad oversight of the bankruptcy proceedings without direct involvement. Should the details of emergence from bankruptcy not meet the larger public mandate, Congress could still pass legislation to limit funding through the Federal Reserve in the event of egregious abuse of the bankruptcy statutes.

A Solution that Works

Once these basic conditions have been agreed upon, the bankruptcy courts can ensure an orderly execution of the bankruptcy plan. Labor and management would have a new collective agreement which would provide a platform of stable competition. Suppliers could choose to continue their relationship with the automakers, or to find alternative customers. Other automakers could choose to expand their manufacturing base in the United States.

Government's coordinated use of the existing process of bankruptcy will achieve the six key outcomes mandated above. By forestalling an uncontrolled spiral of business failures stemming from one or more of the Detroit Three unilaterally declaring a reorganization – or ceasing operations completely – this focused approach provides the basis for a healthy domestic economy. The requirement for basic wage and benefit floors helps to stabilize the middle class while building the basis for a competitive domestic automotive industry. And the use of existing regulation and laws prevents the kind of ad-hoc policymaking that can create significant unintended consequences over time.

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About The Firm

Simplicity Tactics provides crisis management and business turnaround expertise to manufacturing companies, governmental and non-governmental entities, and service firms. Far from basic consulting, Simplicity Tactics helps these organizations implement their short and long term strategies by offering hands-on operational direction, tools, and performance management systems.

ⁱ CAR Research Memorandum, "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers" November 4 2008.