

PREPACKAGED BANKRUPTCY: BE CAREFUL OF WHAT YOU WISH FOR

Ari links to a Barry Ritholtz post reporting that President-elect Obama is considering a pre-packaged bankruptcy for the Big Two and a Half (presumably just for the one and a half that are GM and Chrysler, as Ford is not yet at that point). Ritholtz (who undoubtedly knows more about the economy than me) declares this plan a winner.

Smart:

[snip]

This remains the best option IMO for Detroit . . .

Barry? President-Elect Barry? Be careful of what you wish for.

Bankruptcy is a positively genius idea, except for the ways it isn't a genius idea.

Bankruptcy Would Allow the Big Two and Half to Reneg on Pension Claims

The first thing bankruptcy would allow the Big Two and a Half to do is get out of their overwhelming obligation to pay retirees' pensions. That would, instantly, eliminate one of the biggest remaining competitive disadvantages between American manufacturers and the Japanese and would therefore make a lot of unprofitable car lines profitable, almost immediately.

Voila! GM can now compete with the Camry.

However, the Pension Benefit Guarantee Company would then pick up those pension obligations. Rather than giving the auto companies the money, you'd be paying it directly to the retirees. But

taxpayers would still pay.

Bankruptcy Would Allow the Big Two and a Half to Break Dealer Contracts

A far more important advantage—from a competitive/restructuring standpoint—is that it would allow the manufacturers to break their contracts with a bunch of dealers. This would allow the manufacturers to shed dealers almost immediately, with the salutary effect that dealers in the same town wouldn't be competing for the same customer, and therefore would be less tempted to make big cuts in the price of the car to keep a customer. This would, in turn, have the effect of restoring much of the value of the brand that is currently lost in the never-ending festival of rebates. And it would raise the profit on every car sold.

Furthermore, by breaking dealer contracts, the Big Two and a Half could change the profit model of dealers, such that they expect a one-time profit to sell the car itself, rather than a lifetime of service opportunities for each client. The Big Two and a Half are going to have to do this anyway to move away from the combustion engine (though that change is far down the road). So why not make that change now—move away from the entire dealer-network concept of marketing a car?

Of course, those contractual changes would have two effects. First, if you shed one third to a half of the 10,000 dealers spread out across the country, you're going to have a lot of people out of work suddenly—in towns and cities pretty evenly spread out across the country. Those people are going to be drawing on government benefits while they look for another job—if they can find one. You're also going to have dealers with a bunch of debt on their hands, but no business to help them pay off their debt (as opposed to the current method of shedding dealers, in which the dealers get an upside in the process). Again, that's going to affect the economy across the country. And finally, once the dealers do move away from a service-based

profit model, you're going to find a lot of highly skilled mechanics working for smaller entities, in many cases with more marginal jobs. They'll find new jobs easily enough, I guess—until we move to electric cars, someone will have to service the cars we've got. But they may give up a deal of security and prosperity with the move.

Bankruptcy Would Allow the Big Two and a Half to Miss Its VEBA Payments

One of the reasons the Big Two and a Half are so cash strapped right now is that they are due to pay the UAW installments on their big one-time payments next year (this is not immediate, but it is a looming cost). If they miss those payments, presumably the union wouldn't have the cash to fund the health care fund—designated to provide health care for the UAW retirees, particularly those between the age of 48 and 85 who are not yet eligible for Medicare. If those retirees lose their healthcare, they're either going to have to go without healthcare or, depending on other factors, they're going to go on Medicaid.

Bankruptcy Would Allow the Big Two and a Half to Break the Union

Ah, breaking the union. Every bankruptcy advocate's wet dream.

If the Big Two and a Half went bankrupt, you would break the union, renegotiating existing contracts, presumably by cutting the skilled workers' pay, but not raising the second tier of workers negotiated in the last contract. This would (because the second UAW tier is actually much lower than the Toyota or Honda tier) actually bring labor costs down **below** those of the Japanese rivals, again making smaller more efficient cars much more profitable overnight.

Maybe those skilled workers will muddle through. Maybe you'll see a big increase in credit defaults and individual bankruptcy as people try to adjust to dramatically smaller salaries.

Sure, you might sacrifice safety at the plants.
Sure you might even sacrifice some of the
quality in the plants.

And golly, if you're a President-elect who just
won the Mid-West—including Indiana, for
chrissakes!!—largely with the help of the UAW,
you'd be facing big electoral problems.

But it'd accomplish something that the union has
already set into place to accomplish, evening
out the pay disparity between the Big Two and a
Half and their Japanese competitors.

Now, as you can see, there's a lot to like in a
bankruptcy, as it would allow the Big Two and a
Half to do immediately some things they're doing
more slowly (evening out wage disparities and
shedding dealers) or not yet doing (reneging on
pension guarantees and health care promises). Of
course, you'd be doing that at a time when such
an immediate shock to the system might well be
the shock we're all trying to avoid with a Big
Two and a Half collapse. And you'd also
accelerate the process by which the federal
government picks up some of these costs, but in
a way that has little upside for the economy.

[Note, this was a bit flip—I invite those of you
who work in bankruptcy to straighten out my
misconceptions.]