Reflections on the Auto Restructurings

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In the course of my Treasury service and since then, I've found myself repeatedly responding to a few seminal questions concerning President Obama's actions surrounding the auto crisis. In that context, I intend today to provide some background on our work, address these major questions, and close with a brief look ahead.

Just to review, the auto crisis unfortunately reached a crescendo soon after the presidential election. You'll recall that Congress declined to act, and President Bush decided in late December to provide $17.4 billion of TARP funding to GM and Chrysler.

President Obama and his transition team understood the stop-gap nature of that funding. In that context, incoming Treasury Secretary Tim Geithner and incoming National Economic Council director Larry Summers quickly concluded that given the magnitude of the overall economic crisis, they should create a dedicated team to focus on this critical but discrete problem.

With the attention these days surrounding czars, it is important to emphasize that neither I nor anyone else on Team Auto was ever a czar or even a czarette. We reported to Tim and Larry and only through them to the President, just like our counterparts addressing other economic problems. The czar stuff arose largely because the failed legislation that I just referred to would have created a true auto czar. But President Obama's view was to accept responsibility for this problem rather than try to outsource it.

The President created two task forces: A cabinet-level group and an assemblage of sub-cabinet economic thinkers. Our working group, which was mostly based at Treasury, represented in essence a third "task force."

As we were getting underway, the two companies filed mandated "viability plans" on February 17th. Those plans evinced a state of denial as to the magnitude of their problems, the necessary changes and the conditions under which the Administration might provide further assistance.

Both companies needed massive reductions in their costs and liabilities, including their legacy health care obligations, their labor costs, and their manufacturing footprints. The President and his senior advisers were of one mind: No more money except in the context of shared sacrifice and restructurings to become truly viable.

It was frustrating that many commentators were suggesting that the government stay on the sidelines and let the companies fend for themselves. With financial markets

still frozen, both would have unquestionably run out of cash quickly, slid into bankruptcy, closed their doors and liquidated.

That would have meant the elimination of more than two-thirds of American-owned auto manufacturing capability, cost more than a million jobs in the short run, dramatically deepened and prolonged the nationwide recession and pushed unemployment rates in several states above 20%.

So the stakes were high. In addition to time with the companies, we met extensively with both industry experts and the various stakeholders. We were startled that each stakeholder meeting invariably included a set of "asks" from the government; we had foolishly assumed that stakeholders eager to help would come with "gives".

We realized that convincing stakeholders that the government wasn't going to be everyone's piggy bank might well necessitate a bankruptcy element. While changes like renegotiating a labor agreement could be done without bankruptcy because only a single point of negotiation was involved, other important steps - such as reducing debt - involved innumerable individual actors and would be difficult to implement without the cleansing nature of bankruptcy.

But bankruptcy was scary. Most importantly, we shared the concern of many that consumers might be unwilling to buy such a long-lived product with important warrantee protection from a bankrupt company. We sought ways of mitigating this risk, such as by having the government guarantee warrantees for GM and Chrysler cars.

And we were fearful about the length of a traditional Chapter 11 proceeding. Delphi, the large parts manufacturer, had been stuck in bankruptcy for more than three years. To address this, we decided to utilize an established but less frequently used part of the bankruptcy code – Section 363 – to achieve the restructurings. Under that section, a newly formed company would buy the desirable assets from the bankrupt entity and immediately begin operating as a solvent corporation.

But make no mistake. These two risks could easily have meant a hemorrhaging of cash beyond the means of TARP and certain failure.

As we studied the companies, we realized that GM, while deeply troubled, was still a global company with improving products, the second largest market share in the U.S. and strong operations in important countries like China. We soon could not imagine this country without an automaker of the scale and scope of General Motors. The task became not whether to save GM but how to save GM.

Chrysler was tougher, having been larded up with debt, hollowed out by years of mismanagement, and operating as just a North American player. Chrysler, for example, did not have a single car that was recommended by Consumer Reports.

The question for us – and ultimately, the President – was whether any restructuring could save Chrysler. This most difficult decision was debated at great length with Secretary Geithner, Director Summers and several members of the sub-cabinet task force that I described earlier.

Those who felt Chrysler should be allowed to liquidate noted that buyers of Chrysler's most attractive vehicles – Jeeps, minivans and trucks – were likely to turn to Ford and GM. Thus, the substitution effect would eventually reduce the net job losses substantially.

Equally importantly, these additional sales would translate into additional profits for GM, significantly increasing the value of the company and the government's stake.

The group was torn and so were Tim, Larry and I. We intuited that the substitution analysis was more right than wrong and that from a highly theoretical point of view, the correct decision could be to let Chrysler go. But facing a short-term job loss of 300,000 amidst the worst downturn since the Great Depression, a liquidation felt like an unacceptable risk if Chrysler could be viable.

However, to underwrite Chrysler's viability, we believed it needed a strong corporate partner. The only apparent possibility was Fiat, which had been recently revived by its own new management team. Fiat also had stylish small cars and fuel sipping engines.

At GM, we faced a bigger management challenge than even its reputation led us to expect. Take, for example, the lack of financial discipline. We saw no indication of the finance staff pushing back on the operating divisions to achieve better results, as is customary. Analyses seemed engineered to support pre-ordained conclusions. Symbolically, we never heard the words "shareholder value."

The cultural deficiencies were equally stunning. At GM's Renaissance Center headquarters, the top brass was sequestered on the uppermost floor, behind locked and guarded glass doors. Executives housed on that floor had elevator cards that allowed them to descend directly to their private garage without mixing with lower ranking colleagues.

In that insular world, Chairman and CEO Rick Wagoner and his team appeared to believe that virtually all their problems resulted from some combination of the financial crisis, oil prices, the yen-dollar exchange rate and the UAW.

It seemed obvious that any CEO who had burned through $44 billion of cash in 15 months should not continue. Less clear was whether GM would be better off with Rick's deputy, Fritz Henderson or with an outsider, as Ford had done in bringing in Boeing executive Alan Mullaly.

On one hand, few major companies have effected the cultural change GM needs without fresh blood. At the same time, we were exceedingly nervous about the likelihood of recruiting a thoroughbred outside player, particularly in the midst of the turmoil.

Meanwhile, the government had recently forced Citigroup to replace a majority of its board. If ever a board needed changing, it was GM's, which had been utterly docile in the face of looming disaster.

After much discussion, Secretary Geithner and Director Summers decided to recommend a package that would include replacing Rick with Fritz, changing at least half of the board and making an outside director chairman (which should be a universal practice).

On March 26th, members of the task forces had two meetings with the President and his most senior advisers for him to make his decisions.

The President had absorbed his previous briefings and read our memos carefully, allowing the conversation to move quickly to Chrysler. After reviewing the arguments, the President came down where Tim, Larry and I were: Chrysler had the potential to be viable within a Fiat alliance, and given that the state of the economy was so fragile – particularly in the industrial Midwest – the right decision was to make TARP funds available.

The President's March 30th speech consisted of a set of extraordinarily tough and muscular steps. The departure of Rick Wagoner leaked first. I was stunned by the suggestion that the government was somehow out of bounds for asking a CEO who had lost $13 billion of taxpayer money in three months and was now asking for more to step aside. In addition, it was commonplace in the private sector for a large investor to tie a new capital infusion to a management change. Moreover, the previous Administration had made similar changes at Fannie Mae, Freddie Mac and AIG in the context of providing assistance.

The more important news, of course, was the President's willingness to have both companies go through bankruptcy if necessary. While that critical decision caused much angst – including among strong supporters of the President's in Michigan and elsewhere – it dramatically changed the nature of the discussions that we were having with the stakeholders, particularly the senior lenders to Chrysler.

These secured lenders had been insisting that they were entitled to repayment of their entire $6.9 billion. From the outset, that had struck us as ridiculous. The debt was trading at about 15 cents on the dollar and according to Chrysler's analysis, the liquidation value of the company was around $1 billion. Clearly, the secured creditors didn't believe that the government would push back and let the lenders have the company.

Until the President spoke. Immediately, the tone of the lenders – and all the stakeholders changed – reinforcing the correctness of the President's decision to take a firm line.

In the ensuing negotiations, the lenders were particularly aggrieved that the UAW's health care trust (known as the VEBA), which ranked below the secured creditors, was slated to exchange a $8 billion existing claim for $4.6 billion in notes and 55% of the equity in the reorganized company.

Fairly valued, we believed the VEBA was receiving a bit more than half of its prior claim, a higher percentage recovery than we were offering to the more senior secured lenders. These lenders felt that this represented a tilt by the Obama Administration in favor of labor and against capital.

That was simply not the case. At no time did the White House ever ask us to favor or punish any stakeholder. Indeed, we were encouraged to approach the restructurings from a private sector perspective. Ironically, the governmental pressures we faced ultimately came not from within the Administration but from Congress and local officials.

And while many highlighted the disparate treatment between the senior lenders and the VEBA, they chose to ignore the fact that many other unsecured creditors – notably, suppliers and consumers holding warrantees – received 100 cents on the dollar. The fact was, Chrysler needed workers, suppliers and customers to succeed and therefore needed to give them more.

This situation was hardly unique to Chrysler. For example, in the steel industry bankruptcies, stakeholders were regularly afforded disparate treatment for analogous reasons.

Moreover, if we had given the VEBA or other stakeholders less, we wouldn't have given the lenders more; the $2 billion that they ultimately received represented a generous premium over both the trading value and the liquidation value of their holdings.

In short, the outcome of the Chrysler restructuring had almost nothing to do with the heavy hand of government and everything to do with the fact that Treasury was the investor of last resort.

We were also accused of having run roughshod over bankruptcy law and precedent. Not true either. While I'm proud of the creativity of our team, every step proceeded normally through the legal system and followed existing bankruptcy law. In fact, early on we had considered and rejected as unnecessary many suggestions that we seek special bankruptcy law.

Equally importantly, the White House never tried to use the auto restructurings to achieve any other policy goals. While we were at work, new fuel efficiency standards

was negotiated by the Administration with all automakers – without any involvement on our part. And we were never asked (or ordered) to impose any new technology mandates on the companies.

With respect to the companies' restructurings, we believed that they needed to assume that U.S. car sales, which had peaked at 17 million in 2005, might well not get much above 10 million for the next several years.

In the case of GM, it ultimately produced a plan that accelerated the plant closings, eliminated the Pontiac brand, increased the job and dealer reductions, and added white collar job cuts. And like Chrysler, GM reached a new agreement with the UAW that put labor costs on a competitive trajectory.

All told, GM's debt-related liabilities were reduced from $120 billion to $55 billion and $8 billion a year of North American structural costs were eliminated. These painful cuts lowered GM's break even point from a 16.5 million car sales rate to a 10 million car sales rate. Only through amputation could GM be saved.

Both companies also had a "brand equity" problem. Their cars often sold for several thousand dollars less than comparable models made by the Asian "transplants." Time and good products can solve this problem and an important part of our investment thesis was that GM's cars were better than the market gave it credit for.

Perhaps because of its lack of financial discipline, GM was in important ways in worse shape than Chrysler. One simple indicator of that was the amount of capital the U.S. government ended up injecting: $12 billion into Chrysler and $50 billion into GM, even though GM's revenues were only roughly three times the size of Chrysler's. So we were faced with a tough decision as to how to contribute that capital. If we made our investment as a loan, GM would continue to be saddled with unmanageably large obligations. The only realistic alternative was to inject most of our capital as equity.

All of us – especially Tim Geithner and Larry Summers – hated the idea of the U.S. Government owning equity in these companies, let alone a majority interest in GM. But we ultimately concluded that it is better to get something for something than to get nothing for something. To mitigate the obvious risks, the Administration developed a set of principles for the "USG as shareholder" that would add strict limits on government involvement post-restructuring to the existing edict that we not ever meddle in day-to-day management decisions.

Among the ideas that was explicitly rejected was putting any government employees or official representatives on these boards. This underscored the need to put in place capable independent boards of directors and strong chairmen. Once again, there was no political interference. Working with Secretary Geithner and Director Summers, we looked particularly for strong former CEO's of significant companies and also wanted to have at least one leading private equity person on each board. I don't believe I have seen even one criticism of the resulting choices.

In addition to GM and Chrysler, we knew that we would need to address the interconnected web of suppliers, finance companies and the like. We agonized over this. Thousands of suppliers have been devastated and more jobs have been lost in the auto sector during this recession than in any other category. But we ultimately concluded that Washington could not solve the problems of every company in every part of this industry. We limited our assistance to guaranteeing payment of GM's and Chrysler's obligations to suppliers willing to pay a fee.

We also knew that saving the two automakers would be insufficient if we did not attend to the problems of their related finance companies. Chrysler Financial and GMAC's issues were more closely related to those of the banking sector and my sympathy grew for those who had been navigating the banking crisis. We ultimately recapitalized GMAC so that it could support new sales by both Chrysler and GM. By the end of some of the toughest discussions of the entire project, the need for financial services regulatory reform was inescapable to me.

We were fortunate to be operating under TARP rules, which allowed us to allocate capital flexibly, without having to return to Congress for additional legislation. As a result, we encountered relatively little Congressional intrusion -- until the two companies virtually simultaneously announced their dealer reduction plans. Every congressional district had dealers, many of whom were well connected politically.

We patiently worked through each grievance and explained that the companies – not the government – made these decisions. But the episode left an indelible impression on me: If we had not had TARP money available and had had to seek Congressional approval for each use of capital, I am convinced that one or both of the automakers would have been forced to liquidate.

Fortunately, the restructurings survived and the companies began to operate as private enterprises, just as the President had outlined and just as we had hoped.

Like any patient that undergoes major surgery, a successful recovery is far from assured. For Chrysler, the biggest challenges are its need to regenerate its product line up and to manage a significantly leveraged balance sheet. In the case of GM, the overarching question mark is whether without an infusion of new blood, its management team can implement the massive cultural change that is needed.

But by dramatically lowering the break even point for both companies, we believed we were creating a healthy margin for error. Most importantly, we based our projections on conservative projections for car sales. Adjusted for new drivers, about 15 million cars a year need to be sold in the U.S. just to keep the fleet from aging, compared to the current sales rate of around 10 million. Consumers can certainly postpone their purchases for a while but the fleet is not going to age indefinitely and no one has yet invented a substitute for the automobile.

We anticipated that the recovery of these companies will take time. No one should expect overnight turnarounds. Recognize the extraordinary progress that has been made since February in the face of every pessimistic prediction. Be patient. Give these companies the time and space that they need – and that we factored into their recapitalizations – to remake themselves into successful companies.

In conclusion, I am proud to have been a part of this critical element of President Obama's economic recovery plan. I believe that the President made tough, courageous and correct decisions at the moment of greatest economic uncertainty in our country. Because of his actions, GM and Chrysler have been given a fresh start and every tool needed to again be profitable industry leaders.

Thank you.