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University of Rochester Roundtable on Bankruptcy and Bailouts: The Case of the US Auto Industry

The GeVa Theatre Rochester, NY February 2, 2009

Panelists: Thomas Jackson, Charles Hughes, James Brickley, Joel Tabas, and Clifford Smith

Moderator: Mark Zupan

■ **Mark Zupan:** Good evening, and welcome to this discussion of a very topical and pressing issue: today's problems with the US auto industry, and the potential role of bankruptcy in dealing with them. I'm Mark Zupan, Dean of the University of Rochester's Simon School of Business, and I will be serving as moderator.

I'm not going to say much about the topic itself—I'll leave that to our panelists, who are the experts. What I will tell you is that bankruptcy, like business school applications, is a "negative beta" activity. In other words, when the market's up, both business school applications and bankruptcy cases tend to go down. But when the market's down, our applications go in the reverse direction, and so does the amount of attention and effort devoted to bankruptcy.

We have five panelists tonight. Three of them—Tom Jackson, Cliff Smith, and Jim Brickley—are distinguished academics from the Simon School faculty. The other two—Charlie Hughes and Joel Tabas—are both Simon School alums who have gone on to become accomplished "practitioners" in their own fields, Charlie as an auto company executive and Joel as a bankruptcy lawyer. I've asked each of our five panelists to provide a brief statement of their thoughts on the problems of the US auto industry, and possible solutions, including Chapter 11, to those problems. After we hear from each of them, we'll open up the discussion to questions from the audience.

Our first speaker will be Tom Jackson. Tom—along with

his former student, Douglas Baird, former dean of the University of Chicago Law School—is widely regarded as one of the world's top two authorities on US bankruptcy law. We feel very privileged to have him at the University of Rochester. From 1995-2005, Tom served as President of the University. Since stepping down from that position, he has held joint appointments at both the Simon School and in the University's political science and economics departments. Before coming to Rochester in '95, he was the provost and dean of the University of Virginia Law School.

So, Tom, would you please start things off for us?

I. The Social Function of Bankruptcy: Uses and Limitations

Tom Jackson: Thanks, Mark, for the kind words. Let me start by saying how much I appreciate this Depression-era stage set that GeVa has provided as the backdrop for our discussion tonight—it seems very appropriate for the topic.

I want to begin this discussion by providing a broad economic framework for this issue of bankruptcy vs. bailouts because I suspect we haven't seen the last of businesses—or industries—facing such choices. My field, as Mark told you, is bankruptcy—and bankruptcy is a process for reorganizing troubled companies that is rooted in the economic goal of increasing efficiency. Bailouts, by contrast, are a means of

rescuing troubled companies where, for good or ill, politics tend to mix with and override fundamental economic considerations. So I'd like to talk about what bankruptcy can do, and perhaps what it can't—and I'll do so in the context of the recent controversy over about what the Detroit automotive manufacturers should have done.

Chapter 11 is designed to do one thing well—and, for the most part, I think it does so. And that is to rearrange the capital structure of companies with more debt than assets to allow those that should survive to survive—and allow those that should fail to fail. The criteria for survival in such cases are economic ones: can the troubled company, if properly reorganized and recapitalized, be made profitable enough for its *new* investors to earn a fair rate of return on their money? If the answer is yes—in which case, presumably, the new capital will be provided—the company gets reorganized under Chapter 11. But if the answer is no, the best outcome for the original investors is to shut down the business and sell the assets piecemeal to the highest bidders, either in Chapter 11 or after converting to Chapter 7.

Whether bankruptcy or bailouts, however, it's important to recognize that there is a difference between *financial* failures and *business* failures. Financial failures are cases where the assets, although valuable when kept together as part of a going concern, are worth less than the liabilities—and these companies, as a general rule, get reorganized in and come out of Chapter 11. Business failures, by contrast, are cases where the assets themselves are worth less when continued as part of a firm—even if the firm were to be recapitalized or given new money—than sold off piecemeal to new owners. In practice, of course, we often see elements of financial and business failure mixed together. But Chapter 11 is premised on the idea of separating these two ideas in such a way that companies facing a financial but not a business failure will be reorganized and continued—and business failures will be sold off in parts.

To see this distinction, consider the case of Johns Manville in the 1970s, a company that appears to have been a very efficient manufacturer of building supplies. The company became hopelessly insolvent not because of any problems with its then-current business line, but because of the tort liability associated with its manufacturing of asbestos 20, 30, and 40 years earlier. Keeping the company going—which required writing down the claims against it and converting many of them to equity interests—was the right outcome since Manville's was a financial and not a business failure. And, again, Chapter 11 is designed to do just that.

Conversely, one can have a business failure without a financial failure. My family had a business in Kalamazoo, Michigan that made gas lights at the turn of the century—a business that was not a growth industry in a world of electric light bulbs. Now, because it made very little use of debt, the

business was able to survive and be converted, over the course of 50 years, into one that makes pneumatic air cylinders—which it continues to do to this day. But if that business had instead been financed with debt, it would almost certainly have filed for bankruptcy. Unless new owners and investors could be convinced that the existing management could effectively make the transition to a new business, the assets would have been sold off in a Chapter 7-type proceeding—and, sooner or later, someone else would have entered the business of pneumatic air cylinders.

But as I suggested earlier, most corporate failures—even those in very large companies—tend to result from a mix of financial and business failure. Part of the blame in such cases can be laid to having the wrong business model, and the current management team may not be quite up to the task. But much of the current problem can also be attributed to past business mistakes in combination with accumulated debts and liabilities that the current management may or may not be responsible for.

And before one can discuss Detroit—and bankruptcy—one needs to figure out which model it fits: Is it mainly a financial failure, a problem that can be addressed largely by rewriting claims and contracts and providing new capital? Is it really at bottom a business failure? Or does it have elements of each that need to be addressed? And, I hasten to add, the same questions need to be asked when designing government “bailouts” as well. It makes no sense to bail out a failed restaurant that was operated by mom and pop. Mom and pop will leave the scene, and someone else will take their place. Any intervention by government will only make things worse.

Detroit has a 40-year—perhaps longer—history of decisions and actions that, in retrospect, have turned out to be wrong. Some, though by no means all, can be blamed on past management. As a result, one or more of the manufacturers in Detroit are almost certainly insolvent in the classic sense: that is, their liabilities exceed their assets. Any solution to Detroit's problems has to figure out how to get these things back in line. I suppose giving them money from the government is one way to do it. But is it the best way?

And when it comes to addressing the question of business failure, one or more of the manufacturers in Detroit are probably also not “efficient” producers any more. But, again, that's not necessarily because its current management is incompetent, but because the accretion of mistakes over the past 40 years has produced manufacturing operations that are not as efficient as its competitors'.

But other than noting the consequences for operations today, the real need here isn't to explain the past. The most important, and often overlooked, question is how to deal with the future. How do we identify and save those parts of the US auto industry that are worth saving? And how do we

ensure that whatever companies emerge from the current mess are profitable enough to stand on their own, and so avoid creating permanent corporate dependents?

And I think it's important here to begin by identifying the fundamental issue, one that often seems to be ignored in the current debate: Is there too much manufacturing capacity going forward in the US auto industry? I'd say "yes, without question." Rather than a baseline of 16 million cars, we need to contemplate a baseline of 12-13 million cars. Auto manufacturing, to be sure, has always been a cyclical business—again, I know first-hand, having grown up in Michigan. Cyclical businesses will fluctuate. But there are a lot of reasons—cars that last longer, perhaps a shift in cars as a "status symbol," and the reality that, even in the early years of this decade, demand seemed to be kept artificially high through a number of devices such as "rebates" and fleet sales—to think that the fluctuations are likely to be around a median level that is two or three million vehicles smaller than it had become over the past decade.

Now, if these estimates are correct, then that is the gorilla in the corner. It means that we need to pull huge capacity out of the system. We can take it out of one or more of the Detroit manufacturers, or we can take it across the board—but either way, the capacity needs to come out. We need to deal with the consequences of doing that. It won't be pretty. It's going to mean shutting down plants, car dealers, and suppliers—and putting people out of work. Once you start with this premise, you then have to ask which method, bailout or bankruptcy, is likely to accomplish this downsizing in the most cost-effective way.

Now, it's probably true that if you decide to take capacity out of the automobile industry as a whole rather than just Detroit, you will "save" jobs. But that is true precisely because *Detroit is less efficient* than the rest of the industry; any time you take jobs out of companies that are *more efficient*, you probably save jobs. But this is as perverse as it

sounds: by trying to prop up less efficient enterprises, you impose large costs on the rest of the economy—on US consumers, who end up paying higher prices for cars; on US taxpayers, who foot the bill for today's (as well as tomorrow's) subsidies. You also impose costs on other, more *efficient* competitors who, although they may be foreign companies, employ lots of US workers—and these companies will get dragged down by the excess capacity preserved by any bailout.

What basis do I have for my claim that Detroit is less efficient? There are many ways to count it, but let me name just a few. Let's start with the number of different kinds of vehicles. GM, which has well over a half-dozen major "brands" of cars in the US alone—not counting distinct brands such as Holden in Australia or Opel in Europe—is the only manufacturer in the world I can think of with more than three lines in one country. Along with too many models, GM also has far too many

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-Tom Jackson

dealers. Both of these are the consequence of early- to mid-20th-century mergers and an earlier strategy that is reflected in the company's name—*General Motors*. With a business model that seemed to work in the 1950s, GM encouraged new buyers to start by buying Chevys and, as they worked their way up the economic ladder, to move to Pontiacs, then Oldsmobiles, then Buicks, and finally Cadillacs. But that model made less and less sense as we entered the latter part of the 20th century and the first part of the 21st century. Changing strategies, under the best of circumstances, would have been difficult—although that doesn't explain why GM continued to *add* brands, such as Saturn and Hummer. And change was made much more difficult by a franchise system for dealers that, with the help of state politicians and law, was effectively frozen in place—and ensured the continued existence of too many brands.

Besides too many models and dealers that cannot be dropped without major expense, another cause of Detroit's current problems was their successful efforts to persuade

lawmakers to limit foreign competition in the 1960s and 1970s. Part of the justification for allowing Detroit to be protected by such barriers to entry were many of the same arguments that we hear today for a bailout, including the desirability of protecting Detroit's ways of doing business and the high wages that came with them. But such wages of course translated into the high labor costs that plague the industry today, as well as its continuing reputation—fair or not—for producing a lower-quality product. In other words, by succeeding in its efforts to limit foreign imports, Detroit not only preserved its high-cost wage structure but effectively guaranteed its own failure to respond effectively to product innovations by its foreign competitors. After all, why change unless you're forced to? Although the difference between Detroit's and other carmakers' US labor costs has been exaggerated—the oft-cited \$70 an hour versus \$45 an hour mistakenly includes retiree pensions as a wage rather than a fixed cost—the reality is something like \$55 an hour versus \$45 an hour, or a 20% difference, which isn't small potatoes.

So, with industry excess capacity and Detroit's inefficiencies as the problem that should be addressed by any intervention—bankruptcy or bailout—the question I'd like to focus on is: What can bankruptcy do to fix the problem?

In the case of the automotive industry, bankruptcy—Chapter 11 in particular—does several things extraordinarily well. But it also faces a couple of serious hurdles.

Let's start with how bankruptcy can "help" Detroit. First, bankruptcy law allows the rejection of what lawyers call "executory contracts"—things such as leases, franchise agreements, supply contracts, and labor contracts. That ability would allow Detroit to convert many obligations to franchisees that are imposed by state law into unsecured claims against the company. To give you some idea of the cost of eliminating those franchise agreements outside of bankruptcy, when GM shut down Oldsmobile it reportedly paid as much as \$2 billion to Olds dealers pursuant to these state laws. So that's Plus 1 for bankruptcy.

Bankruptcy would also probably allow the industry to turn its unfunded pension obligations to retirees into unsecured claims. Unlike current wages, which represent marginal costs, pension obligations to retired workers are fixed costs that have contributed to one or more of Detroit's manufacturers being insolvent. Bankruptcy's ability to deal with accrued pension obligations is Plus 2 for bankruptcy. Now, it's true that the net effect would be to shift those liabilities to the Pension Benefit Guaranty Corporation, and thus to us the taxpayers—and so the end result would be a government subsidy no matter what Congress does. But as I will suggest later, shifting these kinds of one-time "social costs" from the private sector to the government is a better use of subsidies than propping up businesses that need to shrink to survive. By removing the burden of their pension costs, we can get a

much clearer picture of what it will take to turn them into viable standalone enterprises.

Bankruptcy will also allow a manufacturer to reject its current labor contracts, although the union might—and probably would—strike. Still, over all, a Plus 3 for bankruptcy.

A fourth and final benefit of bankruptcy is that someone other than current shareholders and their representatives will be deciding on the appropriate size of these companies going forward. I think this is an important benefit that hasn't received much attention. Once a company is insolvent, its management—put in place by the equity interests that are now under water—are effectively playing with other people's money. Since the equity interests are already under water, they cannot be made any worse off, and so they have a natural tendency both to take greater risks and to drag out any "day of reckoning" in which they will be firmly shut out with nothing. Chapter 11 will transfer that equity ownership to new people, whose money—or financial recovery—will be at risk, and who are thus much more likely to make the best decisions about what to do with the assets going forward. Under Chapter 11, the current management could remain in place; but the decision to keep them there will be in the hands of the new owners—that is to say, the existing creditors whose interests are converted into equity in any reorganized company, as well as the investors that agree to provide funding for the new, slimmed-down companies.

But having discussed the potential benefits of bankruptcy in this setting, what are its limitations—what do we need to worry about?

The biggest question mark for bankruptcy has to do with whether Chapter 11 is a self-fulfilling prophecy in the sense that no one will buy cars from a GM or Ford or Chrysler in bankruptcy. Most of the time when we buy something, we pay little or no attention to the fact that the selling company is in Chapter 11. We don't stop flying on United because it is reorganizing. We don't stop shopping at Bloomingdale's because it is reorganizing. (In fact, Bloomingdale's reportedly achieved new levels of profitability and efficiency when operating in Chapter 11 under Allen Questrom in the '90s.) But that's because we care only about the immediate "thing" we are purchasing. For the most part, if the company ceases to exist after we buy or fly, we don't care.

But that's not true for cars. We care about the warranty. It isn't whether we'll get parts or service—I have little doubt that businesses will spring up to provide that stuff. The question is whether we will get those parts and services "for free"—as our original deal provided—for a period of, say, five years. This right—the warranty—has a certain economic value to the buyer, one that, just to put a number on it, might be estimated at around \$1,000. The problem here is that if you buy a car from GM after it files for Chapter 11, your

warranty claim, while having “administrative expense” priority in GM’s Chapter 11, would be only an unsecured claim in any subsequent liquidation of GM. So unless you are confident that GM will “make it” for the five years for which your warranty is good, you won’t value the warranty at its full \$1,000.

Someone needs to figure out how to deal with this problem. Government guarantees have been held up as a “solution,” but that has a major moral hazard problem—that is to say, if the government guarantees warranties, GM has an incentive to build lousy cars. Another possibility, which to me is more palatable, might be to raise the priority of the warranty claims above those of unsecured creditors in any subsequent liquidation. This solution is likely to be better because it would entrust the question of GM’s reorganizing—and optimal size—to those people whose money would be on the line in the Chapter 11 proceeding.

But even if this issue is solved, the problem of warranties for people who bought GM cars *before* bankruptcy needs to be addressed as well. Those warranty claims would be unsecured claims in Chapter 11. The outcry over that would almost certainly require GM to “assume” those claims as an expense of Chapter 11 as well. Concerns have also been voiced about auto parts being made available—though I tend to think this problem is relatively minor since suppliers will continue, or will spring up, to provide the parts.

At any rate, these are serious issues that require careful thought and responses—indeed, the kind of response that GM (and others) should have been working on in terms of a “prepackaged” bankruptcy instead of putting all their eggs in the bailout basket. (And, by the way, the statements made by GM’s management and board that they “never considered” bankruptcy as an option make sense only in one scenario—a world where Chapter 11 would spell the end of the current equity owners’ interests and where the political branch appeared to hold out the only hope of postponing, if not avoiding, any such day of reckoning.) And if I’m right about the overcapacity problem, Chapter 11 has a lot going for it, and perhaps a lot more than a government bailout.

This isn’t an exercise of imagining a perfect world; it is an exercise of comparing bankruptcy to alternatives and, specifically, to a bailout. If nothing else, bankruptcy—by the “self-selective” nature of the companies that will be using it—is much more likely to focus the solution to the excess capacity problem on that part of the industry the excess capacity *should* come out of—namely, the less efficient producers that are more likely to become insolvent (in part, because such companies tend to find it more expensive to raise new equity). A bailout, on the other hand, which is far more likely to tolerate (or ignore) the excess capacity problem—because taking it seriously requires one to talk about and focus on shutting plants and putting people out of

work—is likely not only to extend the problem, but to make it far worse and even intractable. Even with conditions put around them, bailouts will continue the existence of those companies within an industry that are least deserving of continuation on almost any scale. If you think I’m exaggerating, consider that many of today’s bailout proponents view the proper role of government as returning the industry to its “normal” production of something like 16 million cars a year. This is a clear prescription for an industry that will face “permanent” overcapacity and a predictable series of future crises—and perhaps permanent government support.

Of course, bankruptcy can’t do it all. There is no denying the seriousness of the dislocations and hardship that will be produced—not so much *because of* bankruptcy but because of the underlying need to pull capacity out of the system, one way or another. Dealing with such dislocations seems to me a useful role for governments—and one that isn’t talked about enough. The government, in my view, would be far better off figuring out a good way of providing relief to those harmed by the transition than propping up companies in industries with excess capacity. Doing so will only make the temporary support permanent.

So, my suggestion is to let bankruptcy work, and deal with the issues of overcapacity through a thoughtful government response. This way, we avoid sliding into a “solution” that either ignores the underlying issue of overcapacity or responds to it by spreading the solution around and dragging down *all* manufacturers.

And even if you are unpersuaded by my proposal, let me leave you with one last point: one can’t understand bailouts without understanding bankruptcy. Bankruptcy is an incredibly important and useful tool, one that plays an essential function in a healthy free-market economy—and I think we all understand that such an economy is the underlying source of our collective wealth. Even though it operates company-by-company, bankruptcy can be used to pull excess capacity out of entire industries. It has accomplished as much with the airlines and steel industries. We hardly give it a second thought any more when it is used to take out a Linens ‘n Things—because less efficient than Bed, Bath and Beyond—or a Circuit City—because less efficient than Best Buy. Of course, there has always been a lot of mystique surrounding automobiles—and “what’s good for General Motors is good for the US” But I wonder if the trend toward bailouts—and I do see it as a trend, not just a once-in-a-lifetime response—is the reflection not only of politicians’ perceived demand for immediate government “action,” but also of the public’s and policymakers’ failure to understand the positive role of bankruptcy. Bankruptcy may not always produce the right result, but it most certainly cannot if it is not understood—and therefore not given the chance.

Thank you.

II. The Case for Bailouts

Zupan: Thanks, Tom. One of the great pleasures of my job is getting to see where a degree from the Simon School ends up taking people.

Our next speaker, Charlie Hughes, who's an alum from our class of 1970, is arguably one of the foremost branding experts in the automobile industry. In a career that has included stints as the CEO of both Mazda North America and Land Rover North America, Charlie has managed or represented 11 different brands, domestic as well as international. While running Land Rover, for example, he introduced their sport utility line—built it from scratch in the late '80s during a period of a year and a half, developing a supplier and distributor network, and eventually growing sales of that line to 22,000 per year.

Charlie has also recently co-authored a book called *Branding Iron*, and appeared on national news networks, including Bloomberg, to discuss the auto industry bailout—and, as you might have guessed, he has views on the subject that are going to differ from Tom Jackson's. So, having heard from one of the world's foremost authorities on bankruptcy, let's now hear from someone who has spent his most of his career in the auto industry—someone who can share his firsthand knowledge of not only the industry's weaknesses and vulnerabilities, but also its strengths and accomplishments.

Charlie Hughes: Thanks, Mark, and good evening. My role tonight is to play "Joe the Plumber"—or maybe "Joe the

Mechanic" would be more apt. When I was going to graduate school here in Rochester in the late '60s, I used some of my spare time to modify a 1963 Chevrolet Impala for drag racing on the street. One of my crowning achievements was teaching my wife to beat all the high school kids in that car.

I've been thinking of this evening in terms of three words: *bailout*, *bankruptcy*, or *bust*. When I say that, I'm thinking

not in terms of the Detroit car companies, but rather in terms of our nation. We are a mess. It's not just the banking industry, the housing industry, the car industry; it's the entire country. We are at a crossroads. What kind of a future do we want to have? And, yes, I understand that services are playing a growing role in our economy relative to manufacturing. But are we going to continue to be a nation of makers and builders, or will we end up a nation of money changers?

Like you, I have high hopes for President Obama. Yet one can't help but wonder if he will be pragmatic and tough enough. We are in uncharted waters, and the stimulus package—at least what I've seen of it—is a troubling start. But let's look at how we got here.

We have a failed Presidency behind us, a Congress with approval ratings that would shame a child molester, a financial crisis born of slipshod government oversight, and a widespread ethical meltdown in our financial industry. We have both states and a federal government that are dominated by special interests. I don't know how many of you watched the Congressional hearings where the car companies were taken in hand and taught a few lessons—some of which they deserved. But Nancy Pelosi, our Speaker of the House, couldn't restrain herself from using that occasion to push her green agenda, even if it means sinking our domestic car industry.

As a nation, we are behaving like fourth-generation heirs;

If we are determined to push the social agendas of energy independence and climate control, let's make sure we do it with street smarts and guts. Let's raise the federal gas tax. Let's have one set of regulations for emissions and fuel economy nationwide. (How shortsighted and arrogant is it for people in each state to demand their own emissions standards?) And let's rush—and I do mean rush—to harmonize those standards with Europe. Think of the powerful platform we could achieve if we could get agreement on standards for what's basically 70% of the global car market worldwide—and we could then take that agreement to India and China where the real pollution is occurring and get them on board.

-Charlie Hughes

we don't understand how the business that made us wealthy really works. We apparently don't understand how today's world operates. On too many issues, we are appallingly ignorant.

We are mad at Detroit. During the recent hearings in Washington, six out of ten constituents told their Congressmen to let them die. But these people are clearly unaware of some important realities. The US car companies are far better than you think—though admittedly not as good as they need to be. Let me cite a few facts to make my point:

What company runs the most efficient plant in North America?

The answer is the Chrysler Jeep plant in Toledo. I might also add that Chrysler, which is the company that's in the most trouble of the Big Three, is viewed by industry experts as the equal of Toyota in running the most efficient plants throughout North America.

What line of cars had the best JD Power rating for initial quality in mid-size cars, which is the largest and most competitive segment?

What company had the most cars with IIHS highest rating for crash safety?

The answer is Ford, with 16 cars. Number two was Honda, with 13 cars.

Who builds a large SUV hybrid that gets better mileage than the Toyota Camry?

The answer is General Motors, and the car is the Cadillac Escalade Hybrid. You can't get much bigger than that—and the car gets 20 miles a gallon around town.

And, finally, what is the real difference in pay for factory workers between Toyota and Ford? It's \$9 an hour if you do the calculation the conventional way. But if you factor in the typical bonus the Toyota workers have gotten during the good years—though not this year—the difference is less than \$4 an hour.

But here's the irony I see in what's going on today. What got GM in trouble were its *hubris* and *quick-fix* mentality. As our government tosses around trillion dollar fixes, do the words *hubris* and *quick fix* come to mind? Starting with the credit crisis, to the Wagner Labor Act, CAFÉ, and transplant factory tax subsidies, our government has played no small role in creating the problems of our auto industry in Detroit.

So what's to be done? Here is my short list of suggestions:

First, do no harm. We will debate tonight whether bailout or bankruptcy is the better course. But this is not a lab experiment; and if we get it wrong we are in real trouble. Chapter 11 has never been tested on an industry that is so intertwined with our entire economy.

Second, treat each of the Detroit car companies according to their degree of distress and specific circumstances. Ford, for example, is in reasonably good shape: they have a good plan, a solid cash base, and they haven't taken any money

yet. If they end up needing it, we should support them.

GM is a different story. It's got too much debt, too many brands, and they've already borrowed money—and it needs to demonstrate its long-term viability to receive more. But with that said, I can't imagine this country without them.

And, finally, there's the case of Chrysler, which I think we need to help find an international partner. Fiat has volunteered—and we should see whether that marriage can work. I think our government should continue to support Chrysler until we find out.

Now to my third prescription: if we are determined to push the social agendas of energy independence and climate control, let's make sure we do it with street smarts and guts. Let's raise the federal gas tax. Let's have one set of regulations for emissions and fuel economy nationwide. (How shortsighted and arrogant is it for people in each state to demand their own emissions standards?) And let's rush—and I do mean rush—to harmonize those standards with Europe. Think of the powerful platform we could achieve if we could get agreement on standards for what's basically 70% of the global car market worldwide—and we could then take that agreement to India and China where the real pollution is occurring and get them on board.

Fourth, let's make sure that when we think of our auto industry, we believe in *fair* trade, not one-way free trade. Since World War II, every economy that we would consider to be an economic powerhouse has cultivated a strong, home-based car industry. Germany, France, Japan, Korea, and now China all view their auto industries as springboards to economic growth. Not just for the jobs, or the exports, but because the foundation of technological development in these countries—and ours as well—is the auto industry. You may be surprised to know this, but during the Congressional hearings in December, Silicon Valley came out in support of Detroit saying that if one or two of the Detroit auto companies were to go out of business, at least two big names in technology would follow into Chapter 11.

I've worked for eight different car companies, and six were importers—from Germany, Italy, Britain, and Japan—and I have consulted for the Koreans. All those countries fight fiercely for the success of their homegrown car companies, and in ways we don't fully appreciate. Their car companies are vitally important to them, and they play the game as a team sport.

Sad to say, we are a world champion athlete going to seed. We have gambled our money away and are left staring at our gambling debts. We are at a crossroads; do we want to be a nation of builders—or money changers?

Thank you.

III. The Difference between Automakers and Banks

Zupan: Thanks, Charlie. Now let's hear from Jim Brickley, who is the Gleason Professor of Business Administration at the Simon School. He's an accomplished scholar in organizational economics, competitive policy, corporate governance, and compensation policy. He's also, along with Cliff Smith, one of the co-authors of the leading textbook on organizational architecture. Jim is also a highly regarded teacher on our campus, having been a past recipient of our highest teaching award. He has published extensively on the topics of franchising and vertical organization, is widely regarded as an expert on distribution systems, and has done extensive consulting to law firms and a variety of corporations on topics like organizational design and governance issues as well as franchising and distribution systems.

Jim Brickley: Thanks, Mark. Let me start by saying that the auto industry is clearly very important to the US economy. It employs roughly two million people in manufacturing and in sales and service jobs, and it helps to support many other jobs throughout the economy. It is thus an important contributor to our national GDP, and to our R&D effort as well.

But the American auto companies also, of course, have problems, and they are problems that unfortunately run deeper than the current economic recession. Given the importance of this industry, we all hope that productive solutions to these problems can be found. The question we are discussing here tonight is whether these problems are best addressed through government bailouts or reorganizations using the Chapter 11 bankruptcy process.

But before we get into the case of the auto companies, let's talk briefly about the problems with US banks and financial institutions. People often ask why the government has been so quick to bail out banks and other troubled financial institutions, while at the same time being resistant to the idea of bailing out the auto industry. Aren't both industries important to the economy, and weren't there just as many management blunders in banking as in the auto companies?

The answer is that the banking and auto industries have fundamentally different effects on our overall economy. While policy makers might view bankruptcy as a workable option for auto companies, the use of a similar process in the case of large banks—one that would put a freeze on all creditors' claims—could have far more serious effects on the overall economy. The banking and financial system in an economy is like the circulatory system in a human being; just as people can't survive if their hearts fail and blood doesn't get to vital organs, economies can't function with major disruptions in the flow of credit. Virtually every business of

any size in this country depends on financial institutions to finance its operations and investments. Consumers depend on banks to provide a relatively risk-free place to hold their savings—not to mention their mortgage and auto loans, insurance, and other financial services.

Because of their importance to both businesses and individual savers—and their role in linking the two groups—the failure of major banks and financial institutions would send shockwaves throughout the economy, leading to widespread lack of confidence in the banking system and even financial panic. The bankruptcy of Lehman Brothers gave policymakers a frightening glimpse of the potential for a large domino effect when a big, well-known financial institution defaults on its agreements. That event, along with the near bankruptcy of AIG, resulted in a literal “run on the banks” that threatened Goldman Sachs, Morgan Stanley, and just about every major financial institution in the US. As I already suggested, the financial panic triggered by the failure of leading financial institutions would have restricted the flow of funds to the rest of the economy—even more than it already has—as investors pulled their funds out of the banks, and the banks became increasingly reluctant to lend to consumers, to the business community, and even to one another.

Now, to come back to where I started, the auto industry is very important. Failures in the industry will have harmful effects on many people—including people who work for other auto-related companies—and the overall economy. But having said that, allowing a large manufacturing company to file for bankruptcy, even one as large as GM, would not have the devastating *system-wide* effects that would occur if the government allowed large financial institutions like Chase or Bank of America to default on their obligations. As Tom Jackson was just suggesting, Chapter 11 could well help the auto industry address some of its most pressing problems.

But let's take a closer look at the challenges now facing the auto industry. Wall Street analysts, when discussing the problems of the Big Three auto companies, tend to focus on unions, and on their labor costs and debt. But another critical problem is the inefficiency stemming from their number of brands and models and from their distribution systems, or dealer networks. I think that these issues of corporate strategy and structure are likely to be addressed more effectively through bankruptcy than bailouts.

As Tom told us earlier, the Big Three auto companies developed much of their product lines and dealer networks starting back in the 1950s and '60s, when they dominated the US auto market. It is widely acknowledged that these companies now have far too many brands, models, and dealerships, given their current market shares, which are collectively less than 50% of the US market. The Big Three now market 112 different car and truck models in the US through 15 distinct brands. In contrast, their major

competitors—the top three Japanese companies—offer only about half the choices, with 58 models and seven brands. GM by itself has eight brands and 70 models, and thus more brands and models than the Japanese companies combined.

And as Tom also told you, the Big Three also have far too many dealers. GM currently has some 6,700 dealers that operate 14,000 franchises for its eight brands. Its closest competitor, Toyota, has only 1,200 dealers with just 1,600 franchises, and thus nearly 90% fewer. Now, the auto companies have all recognized the need to reduce their brands, models, and dealerships. But, as Tom said earlier, this is going to be difficult, and very expensive, to accomplish outside of bankruptcy. Auto dealers are a well-organized and powerful political force in their local communities. Over time, they have secured protective legislation in almost all

states that makes it very costly for the auto companies to discontinue brands or close or combine dealerships. For example, it reportedly cost GM over \$1 billion to settle disputes with dealers when they stopped making Oldsmobiles a few years ago.

Now, as Tom also said, in the case of bankruptcy, all of the company's dealer contracts become subject to cancellation and reworking. As a result, the auto companies would have much more flexibility to reconfigure their brands and dealership systems in a quick and efficient way. Of course, some restructuring is going on as we speak. The number of American car dealerships has been falling almost daily as these businesses fail. But relying on local business failures to reduce the number of dealers—thanks to all their legal recourse to and demands on the Big Three for life support—is a very protracted and costly way of addressing the basic problem. What is needed instead are systematic and coordinated changes in these companies' product lines and dealership systems.

State laws not only make it expensive to alter dealership contracts, they also prevent manufacturers from owning their

own dealerships in many states and prohibit direct marketing to consumers through other media such as the Internet. In fact, a number of attempts by the Big Three to introduce new marketing channels have been blocked by dealer-initiated lawsuits or regulatory actions.

I have studied the effects of franchise and dealer protection laws across a broad range of industries. My research indicates that such laws lead to less efficient distribution systems and the destruction of corporate values. Consistent with these findings, a study by the FTC has concluded that state laws preventing auto manufacturers from owning their own dealerships has cost US consumers billions of dollars a year in the form of higher auto prices.

How do we address this problem? It is unrealistic to expect 50 state legislatures to reform these laws in the face of opposition from the local car dealers. My suggestion is that the US

federal government consider national legislation that would supersede state laws and grant the auto companies more flexibility to design efficient distribution systems.

And let me leave you with one final thought: Inefficient franchise laws are but one example of how political considerations often trump economics in legislative or regulatory solutions. Restructuring and consolidating the automobile industry will require many tough choices—and there will be losers as well as winners. Bankruptcy proceedings are much more likely to focus on economic considerations in making these tough choices than a bailout process that involves politicians and politically-motivated "car czars." In the long run, the industry will be much stronger if we allow economics rather than politics to drive the outcome.

While policy makers might view bankruptcy as a workable option for auto companies, the use of a similar process in the case of large banks—one that would put a freeze on all creditors' claims—could have far more serious effects on the overall economy. The banking and financial system in an economy is like the circulatory system in a human being; just as people can't survive if their hearts fail and blood doesn't get to vital organs, economies can't function with major disruptions in the flow of credit.

-Jim Brickley

IV. A Bankruptcy Practitioner's Perspective on Chapter 11

Zupan: Thanks, Jim. Now let's hear from Joel Tabas, a

Simon alum from the class of 1980 and the managing partner of Tabas, Freedman, Soloff and Miller, a Miami-based law firm that specializes in reorganization and bankruptcy. As part of his practice, Joel has dealt with Ponzi schemes, real estate reorganizations, and healthcare workouts and bankruptcies. He has found himself operating airlines, retailers, and restaurants—and participated on creditors' committees in complex reorganization cases involving such names as Planet Hollywood, Brothers Gourmet Coffee, and The Discovery Zone. Joel has graciously agreed to join us tonight in the midst of what are pretty busy times for his business.

Joel Tabas: Thank you, Mark. And let me start by saying that it's a great honor to be taking part in this discussion. Cliff Smith was my finance professor when I was in the MBA program in the late '70s. Tom Jackson's classic article on reform of the US bankruptcy system was required reading when I went to law school. And, like President Jackson, by the way, I too was struck by the stage backdrop behind us. In Miami, we're dealing with an incredibly distressed real estate market—and this Depression-era stage set looks very familiar, makes me feel right at home.

As Tom started out by saying, when evaluating any kind of distressed corporate situation and the range of possible solutions, it's very important to understand what can be accomplished in Chapter 11. Most people have an instinctive aversion to the word "bankruptcy"; they think of it as a death sentence for companies. There's good reason for this: History tell us that about 90% of all companies that enter into a Chapter 11 proceeding for reorganization do not emerge as going concerns; instead they are sold to outside investors or end up liquidating in a Chapter 7 or similar proceeding.

That's the bad news about bankruptcy—but there is some good news here as well. After all, 10% of the companies that file Chapter 11 do emerge as independent viable enterprises. One of the main distinguishing features of such successful reorganizations is planning and preparation. The companies that come out of Chapter 11 tend to be those that carefully explore the potential benefits of a bankruptcy before going into it—they don't just passively react. I would argue that the 90% failure rate is in large part the result of inadequate pre-bankruptcy planning, of the tendency of many companies to wait until it is too late to rehabilitate the business. In this sense, the high rate of failure is not really attributable to the Chapter 11 process itself, but rather to the fact that so many patients arrive in bankruptcy almost "DOA"—in which case they tend to get put on artificial life support for a short period before going into liquidation.

I have represented both debtors and creditors in the reorganization process. If you're helping a debtor negotiate with creditors in a distressed situation, you have to understand—and to make sure that the creditors understand—

the likely outcome of a bankruptcy proceeding. Just the prospect of Chapter 11, with its "automatic stay" provision and the potential rejection of "executor" contracts, is very helpful in getting concessions from lenders and other major claimholders. As Tom mentioned earlier, such claims tend to be reduced significantly in Chapter 11, and are often converted to equity interests. In the case of the auto industry, as Tom also said, Chapter 11 could be very effective in getting concessions from not just creditors, but from the franchisees or dealers and the unions as well.

Another important advantage of bankruptcy—one that could be especially helpful in the case of the US auto makers—is its role in centralizing and coordinating the reorganization process. When dealing with large numbers of creditors that are dispersed around the country and have the option of seeking different venues and courts, a private, out-of-court workout process would be a nightmare—the legal fees and expenses would be astronomical. The beauty of the bankruptcy proceeding is that the debtor files a bankruptcy in one particular forum—and all of the disputes are focused for the most part in that forum. So, instead of General Motors facing litigation throughout the country on franchise disputes, in Chapter 11 it would be handling the litigation involving all of those franchisees in the one forum where the bankruptcy is filed.

So, that is an extraordinary benefit that bankruptcy brings to a situation like this. It focuses the efforts and avoids the potential for inconsistent consequences. Avoiding this possibility is likely to mean some cost savings for the franchisees. One of the things that happens early on in many big bankruptcy cases is the formation of "committees" of creditors or other claimants with similar situations. That was how I got involved in the Planet Hollywood case that Dean Zupan mentioned. My client was a creditor, and we were invited to become part of the committee of unsecured creditors. The role of such committees in such cases is to act pretty much as the boards of directors of public companies are supposed to act. They have fiduciary obligations to their constituents—namely, all the similarly situated, unsecured creditors—that resemble the obligations of corporate directors to the company's shareholders. In other words, they are not supposed to be using the platform for personal gain, or to benefit their clients at the expense of other claimants. They're supposed to be trying to maximize the recovery of all the creditors. They have the right, and are given the resources, to hire professionals—accountants and other financial types as well as accountants—to help them make the managerial decisions that have to be made.

Now, it's true that maximizing the recovery of creditors is not necessarily the same thing as maximizing the health and future viability of the entire enterprise; there is some potential for conflict here, and for a premature liquidation of the

business. But even so, I would argue that the formation and functioning of such creditor committees is a critical feature of the bankruptcy process—one that does not exist at all outside of Chapter 11. I'm a believer in having people with the economic interests involved in the key decisions about the future of the business, especially if a big portion of their claims is going to be converted into equity. I'm convinced that such people are far better able to help fashion how the company will go forward than the typical regulator, who is beholden to all the various constituents of the enterprise.

Moreover, in determining the company's future, debtors are greatly aided by the automatic stay provision I mentioned earlier. By putting a halt to all the disputes and lawsuits, the automatic stay provides a breathing spell that enables all of the constituents—all of the parties to the process—to make important decisions: Can the company be reorganized and restructured in a way that will allow it to succeed? Or is it worth more dead than alive and a candidate for liquidation?

Still another advantage of Chapter 11—and this one is very timely—is its ability to restrain excessive or unearned executive pay. Early on in bankruptcy proceedings, all of the top executives basically have to submit their compensation packages for approval by the court and vetting by the creditors. So, this brings all compensation arrangements out into the daylight. Earlier in this decade, we used to see people filing for compensation packages with golden parachutes. But that practice has now been largely ended by the courts.

Now, let's come back to this issue of franchises that everybody has identified as a big problem for the auto makers. As has already been noted, most states have passed laws that make it very difficult and expensive for the manufacturers to shut down their franchisees. We've been involved with a few Ford franchisees in the Miami area that have recently filed bankruptcy and shut down. I can tell you that they're all struggling—and it's going to be a widespread situation if the economy stays the way it is now, and there are likely to be significant damages to the manufacturers associated shutting down franchises.

But, as Tom pointed out earlier, if a manufacturer files bankruptcy, it could deal with its franchisees' claims in one forum—and everyone could be treated the same. There could even be a committee for the franchisees so that they too could have an economic voice about the firm's future. In fact it's more than likely that, at the end of any successful reorganization process, the franchisees will become significant equity holders in the auto makers—and if this happens, they'll actually have a stake in the health of the underlying business. The same comment also holds, by the way, for the unions: Only after becoming major equity holders are they likely to act in ways designed to preserve the going-concern value of the enterprise.

Another valuable aspect of bankruptcy is its ability to

increase disclosure and transparency. As already mentioned, executive compensation is typically submitted to courts for approval. But professional fees also have to be submitted on a periodic basis for approval with the courts as well. While I've seen studies suggesting that the costs of a bankruptcy proceeding in terms of professional fees would be much higher than in a private workout, I think that there are certain aspects of private workouts that have not been incorporated into the analysis. My guess is that, especially in a case like GM or Chrysler, there would be significant cost savings not only on the debtor's side, but for the creditors as well—because of their coordinated representation by the committees I mentioned.

Another aspect of a bankruptcy proceeding that will facilitate information flow is the provision—specifically rule 2004—that gives any party “in interest”—be it a creditor, an equity holder, or the government in its role as The United States Trustee—the right to obtain financial information from the debtors, including information about their plans to restructure and rehabilitate the debtors. Bankruptcy effectively gives such parties the right to take depositions from the debtor—a right that would not be available outside of a bankruptcy in an out-of-court workout or a bailout situation.

I would also argue that, thanks to years of litigation in high profile cases involving many of the complex issues now facing our auto makers, there is a very well established set of case law and dynamics and parameters that are used by the courts in arriving at the judgments they make about whether to reorganize companies or let them fail. In bankruptcy courts, you will be dealing with jurists who handle reorganizations and feasibility determinations on a regular basis. So you have a very well-developed area of the law that will not be available in an out-of-court situation—where you're likely to see a race by all creditors to a state courthouse instead.

And let me come back to the point about the creditors committees that I made earlier. The committees and other constituents with financial interests are going to determine through a process of negotiation the important features of the company that emerges from a bankruptcy—what products it will continue to make and sell, and how the company will be financed. My own experience suggests that Chapter 11 can provide a cost-effective process for restructuring the companies that are deemed by the court to be worth saving. For one thing, it provides a very effective way of eliminating obstacles to private workouts. One obstacle is holdouts among creditors to a negotiated solution—and the Chapter 11 can be used to “cram down” such a solution. Another obstacle is entrenched managers or owners. It's always tough for someone to admit they've taken the wrong tack—that their management strategies haven't worked and they should not be given another chance. While the process can sometimes

get a bit heated and hostile, I've found that the adversarial process that leads up to confirmation of a plan generally tends to yield a good outcome—one that typically reflects the concerns and interests of all the major constituencies.

Before I close, let me mention one other important advantage of Chapter 11—a feature designed to help debtors raise new capital.

This feature is likely to be most valuable, of course, in cases where the capital markets are otherwise unwilling to provide new capital. That appears to be the case for the US auto makers, which is why the government is contemplating an expansion of the bailout money already provided. The capital markets are not going to be giving money to the Big Three—they're unable to raise

equity or debt—and so they're going to the government. But if one of the auto makers were instead to file for Chapter 11, it could go to the court and say, "To raise new capital, I need to be able to issue super-priority debt financing—debt that is going to come ahead of the other secured creditors in my capital structure." And to the extent they were successful in raising private capital on those terms—which is hard to predict under the current circumstances—the further bailout of the industry could effectively be financed by private investors. If that fails, the other option would be to have the government provide the super-priority financing.

So, there are a number of features of the US bankruptcy code that, in my view, could be used to help US auto makers to work their way out from under their current burdens. And, as President Jackson suggested, they should be weighing all their options very carefully. One reason they should be weighing those options—and its one that I've haven't heard mentioned tonight—is that if the officers and directors of these companies do not consider bankruptcy, and the companies end up in liquidation, the directors could be facing director and officer suits, which is a fertile area of law right now. What those suits are alleging is that is when a company enters what is known as "the zone of insolvency," directors have fiduciary duties that are supposed to shift from the shareholders to the creditors. If directors have failed to consider bankruptcy as a means of preserving the enterprise

value of their companies, they could be facing a D&O suit.

In sum, the auto manufacturers need to carefully consider the possibility that Chapter 11 is the low-cost way of working through their problems and preserving their companies as viable—though likely much smaller—going concerns.

Bankruptcy, for all its flaws and bad press, may have a lot to offer under these circumstances. Thank you.

I'm a believer in having people with the economic interests involved in the key decisions about the future of the business, especially if a big portion of their claims is going to be converted into equity. I'm convinced that such people are far better able to help fashion how the company will go forward than the typical regulator, who is beholden to all the various constituents of the enterprise.

-Joel Tabas

V. The (Long-Run) Costs of Bailouts

Zupan: Thanks, Joel. Barring cleanup tonight on our panel is Cliff Smith, who is the Louise and Henry Epstein Professor of Finance at the Simon School. Cliff is, first of all, an accomplished scholar. He has long been one of the main

editors of the *Journal of Financial Economics*, which is headquartered at the Simon School and, along with the *Journal of Finance*, is one of the top two journals in the field. He's published 16 books and some 90 articles. He won a major prize a year ago for his impact on the field of insurance. He is also a very dedicated and talented teacher. In a career at the Simon School that is now in his 35th year, Cliff has received our full-time MBA Teaching Award ten times and our Executive MBA Teaching Award an amazing 19 times!

Cliff Smith: Thanks, Mark. It's good to be here. As a long-time subscriber, I appreciate what GeVa has done for the local arts community. I want to thank them for letting us use this wonderful facility.

It's become an old saying that people who do not study history are doomed to repeat mistakes that have already been made. I thought it might be useful to look at precedents to our current circumstances, and to try and glean lessons from the past.

When you talk about bailouts in the auto industry, people in the US tend to point to Chrysler as an example of a success story. They will say, "Chrysler got their act together and things worked out wonderfully. Let's just do it again?" Now, if you say that fast enough, and don't think about it very hard, it sounds good. But it's important to remember that Chrysler was not the only bailout that we lived through during the '70s and '80s.

Remember the US savings and loan industry and what happened to it? In the early '80s, when interest rates on Treasury notes and bonds got into double digits, executives from many S&Ls went to Congress looking for help. Since most of these S&Ls were holding mainly long-term fixed-rate mortgages with rates around 5-8%, they were effectively insolvent. My dad was a banker in Greensboro, Georgia in those days, and he liked to tell people, "You can't write 8%, 30-year mortgages, fund them with CDs paying 12%, and expect to make it up on volume."

What happened next? Well, Congress effectively changed the bank accounting standards in such a way that the S&Ls could maintain at least the appearance of solvency and continue to stay in business. So, for the next few years, we had lots of "zombie" S&Ls—they were dead, economically speaking, but were still walking around underwriting risky mortgages and investing in risky commercial real estate. It was those transactions that ended up doing most of the damage. The net result of this regulatory "forbearance" was that, despite the best efforts of the Resolution Trust Corporation ten years later, US taxpayers ended up footing a bill that has been estimated at about \$130 billion.

My point here, then, is that although the S&L bailout is today widely viewed as having been a good thing, what seems to have largely vanished from the collective memory is any sense of the eventual cost of that initial act of forbearance. By failing to deal with the troubled S&Ls effectively in the early '80s, our government turned what would have likely been relatively modest losses into much larger ones.

So, the first lesson from history is that bailouts are a risky business—and not only is the outcome uncertain, but bailouts can have the effect of increasing risk within the system. If you go back and look at accounts in *AutoWeek* of Chrysler's post-bailout success story, you will see articles in the late '70s and early '80s about Chrysler's bold, new, innovative models. As a finance professor, when companies use words like "bold," "new," and "innovative," what I hear is "risky," "risky," "risky." And that leads to an interesting problem for regulators—and of course the rest of us as taxpayers. As the political process is unfolding and people are saying, "Well, the cost that we're forecasting for this bailout is X dollars, and the US auto industry is clearly worth more than that," I would recommend a fair amount of skepticism because those costs are regularly understated by what can turn into scary amounts.

One of the big reasons these cost estimates turn out to be understated is that the behavior of the companies that are bailed out tends to change. They are being given the opportunity, in a sense, to play poker with someone else's money. If you're ever invited to a poker game and allowed to play with someone else's money, I've got a piece of advice: increase your bets.

Bringing out risky new products is one way automakers can do it—but there are others. Before Chrysler got its bailout package in the '70s, product warranties in the industry covered 12 months or 12,000 miles. After Chrysler's debt was guaranteed by us, the taxpayers, Chrysler management decided to expand Chrysler warranties to five years or 50,000 miles.

Now, as things turned out, those bold new products generally were well-received and well-produced. So the resulting warranty claims didn't eat us out of house and home. But think about this from Chrysler's perspective. "We're going to try something that is bold, new, and innovative. If it works, we're heroes. If it doesn't work, we're giving the company to the Treasury." It is like flipping a coin where heads I win tails you lose.

Thus, my second history lesson is that bailouts allow companies to play poker with the taxpayers' money. That is what both Chrysler and the S&Ls did when the government gave them a second chance—and that is what I would expect US automakers to do this time around. We are going to see lots of outsized bets being funded not by private investors, but by taxpayer dollars—bets that are going to be initiated by corporate managers with little to lose and overseen by government officials with limited expertise, and perhaps even less to lose.

My third point is that the forecasted duration of this bailout is something that can easily expand. Think about the history of US agriculture since World War II. During the War, most European wheat fields were turned into battlefields. In response, Roosevelt granted draft deferments to US farmers along with instructions to "crank up production and feed the Allies." And they did a marvelous job.

But what happened after V.E. Day? The swords were turned into plowshares, the European battlefields back into wheat fields, and there was a massive increase in the global supply of agriculture products. The resulting oversupply and plunge in crop prices meant that the US agricultural industry faced hard times.

This huge increase in supply and crash in prices put the US at a political crossroads with respect to its agriculture industry. What was to be done? One option was to do nothing. If the government did nothing, agricultural prices would likely have remained low for two years, or maybe three—and US farmers would have had a tough row to hoe. You would have seen many leaving that industry. Who would have been most likely to leave? Well, the people with the most opportunities other places, those with the most flexibility. So you would have seen younger farmers leaving while older farmers stayed. People with college degrees and more opportunities in other industries would be more likely to go. But after a few years, the wrenching adjustments would have been behind us, and we would have been back in normal operation, though with

far fewer people working in the industry. (And the same, by the way, would likely have been true if the government had not bailed out Chrysler in the early '80s. Had we made the tough choice back then, we would not now be facing the magnitude of problems Detroit is forced to deal with—because the industry, and the overcapacity problem, would likely never have reached their current levels.)

The other choice facing US policymakers back then was of course to bail out the US agriculture industry. And we all know how that one turned out. We decided to *pay* our farmers *not to produce*. That happened in the '40s and then in the '50s—and then again in '60s, '70s, '80s, and '90s. We're still doing it today. If you believe that this bailout of the auto industry is something that we're going to do once and be done with, perhaps you need to think again. The costs of the bailout is likely to turn out to be massively understated—and it could well turn into a kind of perpetual annuity. Thus, the third history lesson is that bailouts can persist—sometimes for decades.

Bailout advocates in Congress regularly announce, "We're not planning on just handing suitcases full of money to General Motors, Ford and Chrysler. We're going to put constraints on what they can do. We're going to put constraints on how they can pay people. Nancy Pelosi is talking about forcing them to start making "green" cars—and she's not talking about her favorite paint color. To me, this begins to sound like allowing the government to run the industry. Unfortunately, the government's track record in running businesses is not the best. Think about Fannie Mae and Freddie Mac—not to mention the US Postal Service. Thus my fourth history lesson is that the government is unlikely to be especially good at running businesses.

We were told earlier that we've never had a bankruptcy applied to an industry that is as large and important to our economy as the US auto industry—and that this crisis is just too big to be managed as an experiment. Yet this same logic should also rule out a bailout: we have never bailed out an industry that is this large and important either (unless we count the agricultural industry). But if we look overseas, history

has provided us with an example. In the 1970s, the U.K. government engineered a bailout of British Leyland, the maker of Austin, Morris, Mini, MG, Rover, and Jaguar. Leyland had a weak balance sheet, contentious labor relations, and inefficient manufacturing; moreover, it had suffered a substantial loss in market share. The U.K. government poured about \$16.5 billion (in current dollars) into the company during the '70s and '80s. The bailout ended up lasting longer

and costing more than had been forecast—and it ultimately failed to save the company: British Leyland eventually went out of business, with select pieces being sold to foreign auto makers.

I think we all agree that we are discussing an incredibly important set of problems for the US auto industry. In making our policy choices, we need to think carefully about the long-run consequences of whatever policy choices get made—

about whether and how these companies can be made to stand on their own, and how many of our taxpayer dollars we are willing to use to see if we can make it happen.

Here in the US, it's always been a very large number of people putting their own intuition into their business models and strategies, and putting their own capital on the line to back their bets. What you wind up with when you allow that kind of experimentation is a very large portfolio of options. As any finance professor will tell you, a portfolio of options is dramatically more valuable than an option on a single portfolio.

-Cliff Smith

VI. Bank Bailouts and the Credit Crunch

Zupan: Thanks, Cliff. I'll now invite the other panelists to join us on the stage, and we will take some questions from the audience. Here's the first one: "Should Lehman Brothers have been forced to go bankrupt?" Tom, can you start us off on that one?

Jackson: Any time you're looking at a large financial institution, there are many more linkages with the rest of the economy, and things are much more complicated. Commercial banks can't use bankruptcy; they need to go through some other regulatory process. In the case of Lehman Brothers, what I've been told by people suggests that it's tied in such an important way to the financial infrastructure that I think they probably should have rescued it instead of letting it go. I think our regulators learned a lesson from that failure. My guess is that they were too quick to believe that this would be the last failure and that we could survive it—and when they quickly saw there would be huge problems unwinding

all the claims, we went back to a model of stepping in. And I suspect it was probably the right thing to do under the circumstances.

Zupan: Next question: “Banks have taken federal monies yet don’t appear to have increased their lending in a significant way? When do you expect the banks to start lending to other companies?” Cliff, can you take a shot at that one?

Smith: Banks are making loans right now to companies with lots of tangible assets and established credit histories. Wall Street will take your debt to public markets if you’ve got a triple A credit rating. But what has happened, and what almost always happens during these kinds of financial dislocations, is that credit spreads have risen dramatically. So the curtailing of access to credit has been most pronounced for businesses with weaker credits.

Now the real problem here is all the uncertainty about how long it is going to take before the economy recovers and, as a result, about how much collateral lies behind the business, and how much debt it is really capable of supporting. Thus, if you’re a start-up company with little in the way of tangible assets and not much of a track record, you’re going to have trouble persuading a commercial bank to make you a loan, or an investment bank to help you raise debt capital.

Hughes: I’d like to jump in here, since I think we’re avoiding the biggest issue with the banks—namely, their unwillingness to lend to each other because they don’t trust each others’ balance sheets. I think there are two main ways out of this problem: the Japan model and the Swedish model. The Japanese approach was to accommodate the banks, to allow them to continue to operate and make more loans while cleaning up their balance sheets very gradually. The Swedes said, “We’ve got to clean up the balance sheets right away and we’ll nationalize the banks—take temporary ownership and control of them—to accomplish that.” Sweden came back pretty quickly while Japan was in a recession for over ten years.

So, while I think it was good that the government pumped in some cash and kept other institutions from collapsing, I think we’re avoiding the big issue. You can’t have a banking system where institutions can’t trust each others’ balance sheets. It’s like a game of liar’s poker.

Tabas: I represent some local banks in Miami, and the amount of new loans—particularly real estate loans—are down as much 90% in some cases. One of my best friends, a well-known appraiser in Miami, is refusing to appraise residential real estate values because the prices on single-family homes have plummeted about 40% on average—and condominiums are down 50% or more. Because of this situation, banks are being forced to write down their assets. One local bank recently wrote down its real estate-based assets from about \$6 billion to \$4 billion—and because of their capital requirements, it’s very hard for them to make new

loans.

And this is a kind of a self-perpetuating problem in the sense that the markdowns and capital requirements seem to be compounding the difficulties, creating a downward spiral. Our real estate market clearly overshot on the way up ’04 and ’05. Now I think it has overshot on the way down. But market participants tend to overreact—and in some cases perhaps bank regulators, too. The result is that right now people in Miami are not able to borrow money for real estate from banks.

Jackson: I think that cleaning up the banks’ balance sheets is a necessary but not a sufficient step in dealing with our present problems. Even if you clean up their balance sheets, the banks have to make sure that the people who are trying to borrow the money are capable of repaying the loans—because if they’re not, then we’ve only added to the existing troubles. Things look awfully murky out there. As Joel said, they’re having a tough time getting people to step up and make appraisals on the properties. So it hasn’t been a big surprise to me that the bailouts have failed to produce an immediate increase in bank lending. That’s going to take time.

So, this is a very complicated and multi-faceted problem—and cleaning up the balance sheets is, as I said, a *necessary* part of the process of getting credit flowing again. But other things have to happen too.

Smith: Well, in thinking about this question, I think it’s important to start with an understanding of what banks have a comparative advantage in doing. If you are a fairly large business with a good track record of producing earnings and cash flow, your first choice will typically be to go to Wall Street and have them package your debt as a public issue. Banks, on the other hand, tend to finance smaller companies that, even if publicly traded, have substantially less information produced about them. For regional and community banks in particular, it’s these kinds of smaller, more opaque enterprises that have always been their bread and butter. Another way of saying this is that banks acquire a lot of what’s known as “specific knowledge” about their corporate clients—the kind that is not easily transferred from one lender to another.

And that suggests that this idea of cleaning up bank balance sheets so they can start trusting each other has some important limits. Financial institutions—and particularly smaller banks—are by their nature somewhat opaque institutions that hold many assets that are difficult for outsiders to value. That’s why I’m frankly skeptical about the government’s plan to buy troubled assets. In cases where insiders have an advantage over outsiders in valuing bank-originated assets—and as I say, that’s especially been true of the smaller regional banks—I think it makes more sense to recapitalize those banks

with infusions of equity than to buy individual assets.

VII. Global Competition and Jobs

Zupan: Next question: “Does reduction of capacity in US industries imply that American workers are supposed to relocate to foreign countries to work?”

Hughes: I don’t think many people are aware of this, but before the credit crisis began to set in, both General Motors and Ford went through massive restructurings that took out almost half of their production capacity. They were forced to buy out thousands of workers at \$140,000 a shot because of contracts with the UAW. I think they were pretty smart and decisive in doing that. Had they not done that, the companies would be in much more trouble than they are now.

But, if I can be a little patriotic, I find it bizarre to say, “We’ve got three million units worth of excess capacity; let’s take it out of the US producers.” If we were to do this, we would be the only country in the world to take that approach.

Jackson: I don’t think this question of domestic versus foreign production is nearly as simple as you make it out. Some of G.M.’s most efficient operations are manufacturers in other countries, such as Holden in Australia. Obviously a lot of the foreign companies have now built US plants that employ US workers. So distinguishing between US versus foreign production is not straightforward. The real question here is whether we are going to continue to have the capacity to produce 16 million cars when we don’t need it. I think that using taxpayer dollars to subsidize that overproduction is a terrible idea, and that we have to figure out some way to take capacity out of the system. I don’t believe that the jobs lost by Detroit are necessarily going overseas—they’re just going to be shifted to more efficient producers here in the US, most of them, I would guess, in the service sector rather than manufacturing.

Brickley: To expand on Tom’s point, something like 60-70% of the Toyotas that are sold in this country are also assembled in this country. Since there are lots of American investors who own shares in Toyota, it’s no longer even clear what it means to be a *foreign* company. As Tom said, Honda, Toyota, and the other Japanese companies employ lots of US workers here in the US. And since GM now imports parts that are made all over the world, I’m not sure it even makes sense to talk about a US-produced car.

Hughes: That’s all true. But we still import a huge number of cars. Again, I find it very odd that we would be having any conversation where people say, “We should be supporting cars that are built somewhere else over cars that are built here.” I’m not talking about putting tariffs on imports. My point is that, in the past few years, the Big Three have already made huge efforts to take out excess capacity; and although we may well have three million units of excess capacity in

the US, not all of that capacity is sitting in the United States. So if we are talking about supporting our US producers—and there now seems to be a national and political will to do that—then it seems to me that we should be willing to provide the capital needed to rehabilitate them. This way, and given some time, they can *become* the efficient producers that we want.

VIII. The Role of Greed

Zupan: Another question: “It seems that all the problems we’re currently dealing with can ultimately be traced to greed. When will we learn how to deal with this?”

Smith: I’ll tell you when. When the physicists figure out how to repeal the law of gravity, the economists will be right behind them repealing the law of demand and abolishing greed. All you can do is to recognize greed—or what we economists call “self interest”—and then try to set up our institutions so that self interest becomes mainly a force for good. That’s a matter of getting the incentives right inside organizations—something that I believe is incredibly important.

Brickley: Greed is a pretty loaded term, I agree. When you hear it, it’s important to keep in mind what another guy named Smith—not an economics professor, but a Professor of *Moral Philosophy*—told us over 200 years ago. Adam Smith’s message was that self interest plays a very important role in creating lots of the good things that we all take for granted. It drives innovation, all the new products and services that are the real source of prosperity.

Now, one question we are asking is whether people are any more self-interested now than they were, say, in the caveman era. But, as the environment becomes more complex, there are new and sometimes destructive ways to pursue self-interest—things like the off balance sheet partnerships that brought down Enron and some of the more speculative uses of derivatives by companies that we’ve seen in recent years. You couldn’t have done these things 20 years ago because the financial instruments just weren’t available.

Smith: And to add to what Jim’s just said, I think it make sense to view our entire financial system as engaged in a kind of Darwinian process of trial and error. We keep trying different things, we make mistakes—and then we learn from our mistakes and make adjustments. One of the strengths of capitalism is that it tends to prevent people from persisting in error, making the same mistakes over and over again. We will no doubt make mistakes in the future. We will continue to have boom and bust cycles of the kind we’re now going through.

Now, one important lesson underscored by recent experience is that problems are going to arise whenever individuals and companies are granted a lot of “free

options”—that is, whenever they can acquire assets or do deals without putting any of their own capital at risk. We saw that kind of behavior by people getting mortgages—and also by banks that originated the mortgages with the idea of securitizing and selling off as much as they could. That’s a clear prescription for too many mortgages and too many securitized deals.

Jackson: True, but it wasn’t just opportunistic or greedy lenders and homeowners at work here; government policy clearly had a hand in producing the housing and mortgage bubble. It was government policy, pushed by Republicans and Democrats alike, that effectively encouraged lenders to drop standard downpayment requirements and come up with creative financing—all with the idea of realizing a bipartisan government notion that everybody should own a home. When people and institutions respond in predictable ways to those policy initiatives, I’m not sure we learn much from identifying the source of such behavior as “greed.”

Hughes: That’s all true. On the other hand, I tend to think that behavior crosses the line from financial incentive to greed when you have a financial community that’s willing to sink a global economy. When you look at how the banks bundled these mortgages into securities—bringing in the best and the brightest from places like MIT to do the statistical analysis to put these packages together, and ending up with leverage ratios of 40 to one—you have to ask how that all came about. I don’t know many bankers that are comfortable with the idea of operating with that kind of leverage. I think that at that point you can say that the driving force was greed.

IX. Solving the Dealer Problem

Zupan: Ok, we have time for one more question, and here it is: “Instead of relying on bankruptcy, wouldn’t it be better to deal directly with the adverse effects of franchising and dealer protection laws just by changing state and Federal law?” Jim, you’re the expert on franchising, why don’t you take this one?

Brickley: Well, I see two different issues here. One has to do with the states, almost all of which have these laws that make it difficult for the auto companies to operate efficiently. Now, the dealers have to worry about protecting their investments—and I think much if not all of this protection could be provided by private contracts with the manufacturer. I think it’s important for the government to back these contracts. But the way things are now, the automakers are prohibited by state laws from owning dealerships—and they are also prevented from selling cars directly to consumers over the Internet. I think both of these prohibitions are sources of inefficiency that increase the cost of automobiles—and, in my view, they should be overridden by federal legislation.

The second issue raised by the dealers—by, say, General

Motors’ need to deal with 14,000 franchise contracts—is one that I don’t think can be addressed effectively by legislative action. To have a chance of becoming a competitive producer, GM must renegotiate these contracts. But, as Tom said before, this renegotiation is going to be very difficult outside of bankruptcy. If they try to accomplish this outside Chapter 11, people are going to be fighting over pieces of the pie instead of trying to preserve the overall operating value of the firm.

So I think that the federal government can address some of the restrictions on the auto makers’ dealings with their dealers. There are more and very urgent problems that cannot be handled through legislation.

Jackson: Like Jim, I think it would be great if we could remove some of these inefficiencies through legislation—and without resorting to Chapter 11. The history of the last 20 years of General Motors would probably look very different if the company hadn’t been forced to contend with the state franchise laws. But getting political action on this is likely to be difficult. As Jim mentioned, there’s no doubt that such changes would be blocked at the state level. But whether they could be accomplished at the federal level is also highly questionable. It’s this uncertainty about the political process that makes me think that bankruptcy is the right way to go. As I said earlier, the rejection of executor contracts in bankruptcy suggests that Chapter 11 is the ready-made solution to these franchise problems.

So, I agree with the premise of the question that a legislated, across-the-board solution would be preferred if possible. But given the realities of the political process, I don’t think we can get it done.

Smith: Let me add to Tom’s point. It’s a fairly well-established principle in political science that these kinds of “collective action” problems are generally likely to be intractable. You’re extraordinarily unlikely to get a political solution in this case simply because the people who benefit from these franchise laws represent a small number of well-organized people with large concentrated benefits—namely, the profits from the dealerships. At the same time, the people hurt by these laws—namely, anybody who ever bought a car—are a widely dispersed group of individuals, each bearing a relatively small cost and having little interest in the issue.

So this is the collective action problem at work. It’s hard to get millions of people excited about being mugged for a few hundred bucks each when that winds up transferring suitcases full of money to people who get big benefits and make big political contributions. That problem keeps a lot of politicians from forgetting about their commitment to the public good.

Hughes: I want to jump in here. In talking about the dealers, I agree that we probably don’t have the will to make a lot of changes that we should. I agree that we should have

a federal franchise law. If a dealer goes out of business, or the company wants to stop doing business with a certain dealer, there should be a contract that says, "This is what we're going to pay you."

We talked about example of GM's shutting down Oldsmobile earlier. No one knows, or is willing to reveal, the actual costs of ending relationships with the dealers—but in that case it was reportedly over \$1 billion, and maybe as high as \$2 billion. That subject's got Rick Wagoner so afraid he won't even touch it anymore. There are now some 440 Saturn dealers that, although excellent dealers, are not making any money. They should be put to rest. Since they also own a lot of other franchises, you would not be putting them out of business.

Now, if it was merely a matter of General Motors going out and saying, "We will buy back the parts and tools, and pay you all the money that we owe in accordance with our contracts," then we wouldn't be talking about anything like \$1.2 billion to \$2 billion. But the dealers are asking for a lot more than that—they want "Blue Sky." The problem, however, is that there is no longer any Blue Sky in the Saturn franchise; it hasn't made any money in the last dozen years. But the dealers are still asking for it—and that's where the problem becomes intractable.

So if we did pass a federal law—though I realize it's unlikely to happen, like a lot of other things we talked about tonight—we could solve that problem. I don't think bankruptcy, by the way, would be the solution to this problem—though when you've called on and negotiated with as many dealers as I have, it sure sounds sweet to be able to do that. But there are other issues that also need to be recognized and addressed.

Let me mention one other interesting piece of auto industry history. There's no question there are some hidden costs and inefficiencies in the system, but at one point in the past, the manufacturers once had the right to their own car dealerships. When the dealers were getting their way with state governments, they succeeded in passing legislation that prevented the automakers from owning dealerships. The interesting thing here is that, behind the scenes, it was people *from the manufacturers* who were working to get this provision passed—because their own dealers were losing so much money that they wanted a way out.

Smith: You mean the manufacturers needed a law to protect them from *themselves*?

Hughes: That's basically right. There are few things more common than believing you can do something as well as somebody else.

Brickley: Well, let me weigh in on this one. If you look at unregulated or less regulated distributor relationships in other industries, you almost never see a so-called "corner solution" where you have either all independent dealerships or 100%

company owned-stores.

Hughes: Right.

Brickley: Most companies use a mix of both arrangements—say, 80% dealerships and 20% dealer-owned stores—depending on variables such as location, and the probability of repeat business. But the state governments have taken that option away from the auto companies. In fact, the governments have even prevented the auto companies from writing their own contracts with the dealers in the sense that the provisions in state law effectively override the contractual agreements where they come into conflict.

Hughes: That isn't the real obstacle. People do buy cars over the Internet every day.

Smith: From the manufacturer?

Hughes: Not from the manufacturer. But I think you're making the assumption that it would be more efficient for the consumer to buy directly from the manufacturer than from the dealer. I think that's a mistake.

Smith: I wasn't making that assumption. I'm assuming that allowing people to experiment with a different model is something that has a lot of value. That by putting a regulatory stop sign at the intersection that says, "You can't turn down that street," you take away that opportunity to learn something you didn't know.

Hughes: Well, let me tell you a bit more about what the dealers actually do. One thing we know is that, when you buy a car, it's probably not the last time you have to go into a dealership. Even Toyotas sometimes have to go back. So there's a whole array of services in a car transaction that go beyond just buying a car. And, at the moment, the industry has a network of dealers that in most instances has been willing to give the cars away for almost nothing, but is there to service and trade them and help buyers sort out their finances in a way that manufacturer cannot do. It does seem to work.

Brickley: Well, let me give you an example of something Ford tried and then got blocked by regulation. In Texas around the year 2000, Ford had a bunch of used cars that they wanted to be able to market directly to buyers over the Internet. The idea was that if they sold the cars, they would then have to contract with some of their dealers to deliver them to the buyers.

But this experiment never got off the ground. The dealers who were not part of these arrangements went to the Texas courts and argued that such arrangements were a violation of Texas law. I agree with Cliff that, by tying your hands behind your back and saying you can't try something, you will never know what might have worked best.

Smith: For those of you here who are old enough to remember, this all reminds me of those discussions back in the '80s about Japanese industrial policy. In those days, publications like *Business Week* and *Fortune* and the *Harvard Business Review* were all talking about how Japan, Inc. was

competing the US right off the map. It was an Al Gore kind of national industrial policy in which the future development of the entire economy was orchestrated by the Japanese Ministry of Finance. What happened in this case is that a very small number of admittedly really smart people made huge coordinated bets with the Japanese manufacturing industry. When those bets turned out well, Japan's productivity soared—and the country ended up moving from ground zero after World War II to being the world's second largest economic power. But that approach seems to have lost its magic in the last two decades.

And that's not the way we do things in the US. Here it's always been a very large number of people putting their own intuition into their business models and strategies, and putting their own capital on the line to back their bets. What we wind up with is a tremendously robust and resilient economy in which literally millions and millions of these small bets are being made all the time. Some of these bets turn out wonderfully—take Google for example. But a lot of them crash and burn—and you rarely hear about them.

Now, the problem with these dealer laws we're talking about is that they absolutely prevent certain kinds of experimentation. You are legally prohibited from trying certain business models and practices. I just want to say that stopping that kind of experimentation is not without costs.

I'm not arguing that if Ford had been allowed to sell cars directly on the Internet, it would have been a multibillion dollar product line for them. In fact, it may well have blown up in their face. My point is more narrow: The problem here is that *we will never know*. I'd much rather have the American business community continue to make thousands of calculated bets, putting their money where their mouth is, than having somebody in Washington or Albany say, "As a regulatory matter, we're not going to let you see if that would work or not."

What you wind up with when you allow that kind of experimentation is a very large portfolio of options. As any finance professor will tell you, a portfolio of options is dramatically more valuable than an option on a single portfolio. The value of the successes is almost sure to outweigh the losses from the failures for a pretty simple reason: options give you right to keep the upside, but cut your losses and move on when you're failing. That's something the US economy has been pretty good at—cutting its losses when necessary and moving on to something more promising.

Zupan: Well, let's leave it at that—and let me thank all of the panelists for taking part in an instructive and entertaining discussion. ■