The Sanctity of Contracts in a World of Bailouts

By

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A Tale of Two Bailouts Major public dustups have the uncanny knack of forcing CEOs, who are often in the line of fire, to ponder fundamental questions about the structure of this nation's economic order. Here are two reasons why. Exhibit A is the saga over executive compensation packages in the financial services industry that erupted this past March after the public outcry over the $165 million in retention payments that AIG promised to key its employees. Unfortunately, these payments were often mislabeled as bonuses, and thus generated a public aura of windfall payments that failing firms made to the same individuals that drove their companies into the ground.

If that had been the case, public scorn would have been amply warranted. But the reality was otherwise. The retention payments were given selectively to those executives whose skills were judged essential to the preservation and revitalization of the firm. Doubtlessly, they were calibrated to the improvement in position that these key employees could bring about. On this issue, what matters is the *improvement* in financial condition, not the original poor baseline. Cutting deficits improves the position of a struggling firm as much as increasing profits. Just observing the size of deferred payments and the profit/loss position supplies no information about the marginal contribution that key workers make to the firm. No short-sighted accounting can possibly explain why AIG's CEO, Edward Liddy, moved heaven and earth to keep his leading people—until the top down Treasury pressure broke his will.

Exhibit B in this sorry saga is the massive Treasury interference with the Chrysler and GM bankruptcies. For months the Obama administration took steps outside of the bankruptcy courts to keep both firms alive. Yet that approach did not allow the two companies do what they had to do, which is to strip away the onerous collective bargaining agreement with the UAW and thin out the dealership networks so as to create an efficient distribution system. But no matter how much money was pumped into the failing firms, they continued to bleed cash because of the inability to rationalize their cost structures. Unfortunately, these overdue bankruptcies did not follow the ordinary rules, because most of the heavy lifting was done politically. The dealers had little clout and a huge fraction of them were terminated. The UAW pension and health funds fared far better. Even though they were unsecured, they were presented with a controlling interest in both companies. Their good fortune came at the expense of the various bondholders, who as secured creditors were entitled the absolute priority rule in bankruptcy to be paid in full before the unsecured creditors got anything. But the political pressures through Treasury inverted the priorities in favor of the UAW.

Private Oversight and Public Indifference The chief lesson from these sorry events is that industry outsiders—President Obama, not excepted—with partial knowledge often make bad judgments about the wisdom of practices that they do not understand. In President Obama's case, the key weakness stems from his misguided prior conviction that all market transactions—from minimum wages to executive compensation—should be subject to political oversight. In fact the sound approach calls for the opposite strategy: Olympian detachment by government officials, let the social critics say what they will. Executive compensation is an internal matter for the firm, to be decided by its directors and shareholders pursuant to the corporate charter and corporate agreements. The posture of lofty indifference is, however, difficult to defend whenever blending of business and regulatory responsibilities makes it impossible for key government officials to do either job well.

The Broader Picture Worse still, these episodes have influence that spreads far beyond the particular case. Right now virtually every financial institution, and every firm that has received bailout money, has to ask of whether its own employment and loan contracts are immune from government revision. That uneasiness has already destabilized the structure of the United States financial services and industrial sectors. Here's why. At root, there are two, and only two, great principles that guide the organization of society. The first protects all persons against external aggression. The second allows them to trade and cooperate with each other through the mechanism of voluntary exchange.

Voluntary exchange is no sterile exercise. Rather it allows people to take advantage of their differential skills, so that the labor, capital, and material goods redeployed by contract are worth more in their reconfigured state than before. When the government takes it upon itself to nullify one half of the transaction, the entire system starts to unravel. Now every compensation agreement, and every is at risk if the government threats of punitive action can executives and bondholders to forgo receipt of their contractual payments. Clearly more than one or two incidents is needed to unravel the network of promises that mark a developed market economy. But every assault takes an additional toll, whose system wide uncertainty swamps the direct losses.

Forward Looking Regulation There are powerful reason to protect all market participants from the retroactive nullification of binding promises. But does that protection suffice to defend the exchange relationship against government interference? Unfortunately, no. Great danger inheres in any government decision to restrict the terms of future voluntary exchanges, for CEOs, commercial creditors, and everyone else.

Start with an extreme illustration close to the hearts of CEOs: the United States Treasury gives due notice so that no CEO may receive any compensation for running a financial services firm. All potential candidates have clear notice of the restriction so that they can mitigate their private losses by steering clear of these no-pay positions. Yet the social losses remain huge even if particular individuals have avoided personal financial embarrassment.

There's no difference in principle by backing off the extreme case by placing wage caps of CEO compensation. A few brave souls might take these jobs, but overall *any* restriction on contract terms imposes a restraint on trade that will knock out mutually beneficial employment contracts. The only debate is over the magnitude of the loss.

Most critics of financial institutions grudgingly accept that position in the abstract, but they argue that the large compensation packages in recent years reflect the cozy culture between CEOs and their corporate boards. But the empirical evidence of director slack is overstated. Historically, CEO compensation tended to rise in near lock step with the dollar value of the assets under management, and that in any event the levels have fallen by as much as a third since 2000. The richer compensation packages figures are also in part a response to shorter tenures in office—itself a sign of more vigorous board oversight. And the amounts offered are often lower than those given to the CEO in private firms, where active board members often have huge personal stakes.

Yet even if individual compensation packages were somehow too high, the greater danger by far lies on government regulation that keeps them too low. There are already many incidents of key employee groups being lured away to rival companies that don't face the compensation restrictions that come with bailout dollars. Any government effort to block this escape hatch could send even more of the financial services industry overseas to more hospitable environments.

Bankruptcy But what should be done with firms that fail? By definition these companies cannot honor all their contractual obligations, so some mechanism—bankruptcy—is needed to minimize the losses of shipwreck. In these circumstances CEO compensation packages are, and ought to be as vulnerable, as any other contract. The dual objectives in dealing with failed firms are first, to let a viable business emerge as a going concern when possible, and, second, to figure out the priority of competing claimants to the smaller pie.

Having watched the various bailout programs run through the White House and the Treasury Department should only increase our admiration for the bankruptcy courts, which normally handle these cases. Once firms fail, the key virtue of bankruptcy courts are two. First, they can establish priorities among the various kinds of contracts. Second, they do *not* have access to some public spigot, which allows for prolongation of the agony. With AIG the bankruptcy courts would have surely hired key personnel at market rates to run its complex operations. But at the same time, it would have hived off all the viable units of the firm into separate entities, which could operate free of the travails of the financial service businesses. But it could not have pumped in billions to honor its various credit default swaps, whose counterparties were other large investment banking houses that were not obvious targets of government largesse. If some additional infusions of capital would be necessary, they would take place against the backdrop of a reformed firm, not some largely unwieldy conglomerate.

The bankruptcy approach makes even greater sense with the big bailouts of General Motors and Chrysler, for there too the piecemeal rationalization of labor and dealership contracts could have prepared for the sale or spinoff of viable economic units, without the political pressures that turned these commercial events into high theater.

So to the larger lesson. Protecting contractual freedom is the best way to avoid true economic meltdowns. And bankruptcy is the best method to deal with the inevitable business failures that do occur. Unfortunately, both the Obama administration and the Congress are committed to neither. And so our current government of meddlesome interference has this double whammy, First it creates economic messes, which then become ever more costly to clean up.

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