

The preferred stock approach to help corporations

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The good news from Washington is that policymakers are making progress on a plan for the COVID-19 crisis. The problem is that many details are missing, and there does not seem to be a coherent plan based on sound economic principles.

One approach under consideration is to lend substantial amounts of money to businesses. Perhaps that is the best way to help some firms, but we don't like the idea of large-scale lending to corporations at low interest rates. Some corporations do need access to cash, but it will be impossible for the government to determine which ones "deserve" the help. To insure some rationality to the allocation of these funds, there should be some kind of price to borrowers which does not interfere with the immediate policy goals. So, here is a (crazy?) idea. Let's have the US government (Fed, Treasury, or some other entity) buy newly issued preferred stock of publicly-traded corporations.

Here are our points:

First, many firms need cash to survive the sudden disruption in business. Some are having supplier problems, some have experienced a sharp downturn in demand, and some have had to shut down but must still pay fixed costs such as rent and interest. Some firms will ultimately go through bankruptcy but that should be determined later when the true long-run economic value of a firm can be determined.

Second, lending adds to corporate debt, and obligations to repay that debt may create future liquidity problems. That problem is only aggravated by using high interest rates to steer government aid to corporations that need the cash most. The obligations from issuing preferred stock can be adjusted to available cash as long as the owners of preferred shares are treated at least as well as owners of common stock.

Third, preferred stock has no voting rights. We do not want government bureaucrats in board rooms.

Fourth, we believe that the US government will make substantial profits from this approach. We believe that the collapse in stock markets is partly due to the rush to cash and not related to long-run fundamentals. Who disagrees with this assessment of future equity values? Some corporate leaders have said they prefer cheap credit to any government equity position. It

sounds like they share our optimistic view. If the US government thinks that it would lose money on these preferred stock investments then we are in far deeper trouble than we thought.

The key point is to get cash to corporations quickly, but do so in a manner that does not create new financial problems, does not interfere with corporate management decisions, but allows the government to share in the upside potential of the future US economy.

We next expand on these points.

Bankruptcies

We must minimize the number of bankruptcies. Our court system does not have the capacity to handle the potential tsunami of bankruptcies.

Many people point to the airlines as examples of where bankruptcies do not disrupt operations. When airlines go through Chapter 11, they can continue operations during bankruptcy through debtor-in-possession (DIP) financing which are loans senior to all other claims. Creditors will participate in DIP financing as long as the cash flow from ongoing business can cover operating costs and DIP obligations and if alternative uses of cash are not better investments.

The past experience with bankrupt airlines is not applicable in these times. The GM situation in December, 2008, is more relevant. GM was about to run out of cash. Private-sector DIP financing at reasonable terms was not available. Chapter 7 -- liquidation of all assets -- was the likely outcome of any GM bankruptcy. Because of this, the Bush administration lent GM money and took an equity position, giving the Obama administration time to work out the reorganization of GM.

Preferred stock

Equity investment by the government is better than loans for helping firms deal with cash flow problems, but we do not want government officials sitting on corporate boards. Preferred stock fits these requirements. All management decisions are still in the hands of the voting shareholders. No government moral hazard. This is not nationalization.

Preferred shares are uncommon in the US because of various legal details, but given the emergency nature of the situation we are sure that this could be changed quickly. We do not know all the various details of existing types of preferred stock. There may need to be changes in tax law and regulations but do lawyers have anything better to do at this time?

There is one important detail left to discuss: price. The lack of preferred stock plus the panic condition of the market makes it difficult to rely on market prices for preferred shares.

Negotiating the price for each corporation could lead to costly delays. In our opinion, the simplest approach would be to have the firm's financial obligations to holders of these preferred shares be the same as their obligations to owners of common shares. In essence, make the preferred shares the same as common shares but with no vote. In that case, market prices tell us the right price for a deal.

The preferred equity approach also helps with reaching some political consensus. Substantial aid to corporations will be opposed by many political leaders. Equity participation allows all to share in the upside potential of these investments.

History

Many of the 2008-2009 bailouts had similar features. The AIG bailout, in particular, was one where the government received substantial equity participation in return for bailout money. The US Treasury claims it made \$22.7B on this deal. While some dispute this number, the point remains: equity participation was a feature of TARP and other interventions.

In the Chrysler bailout in the late 1970's, the government received warrants. Chrysler was saved, Chrysler stock went up and the US made money. However, warrants are not appropriate for the current crisis because price negotiations will cause delays.

These previous bailouts were special deals between the US and the borrower. TARP included equity positions but had many other complicated features. The government was a major player in the GM bankruptcy proceedings and political considerations played a major role in the final settlement.

The firm-by-firm approach of past bailouts is not possible in the current situation because there are too many borrowers and too few government lawyers. Any plan must avoid discretion that may lead to cronyism and political interference. The current situation demands a simple, transparent program where each firm faces the same offer of government assistance, decides how much help they need, and how much equity dilution they pay for that help, all without ceding any control. If a corporation does go bankrupt in the future, the US government claims are settled on terms standard for preferred stock.

Alternative approaches

There may be some other financial mechanisms that could accomplish the same goal more quickly. Perhaps this requires changes in laws regarding what the Fed and/or the Treasury can buy. Perhaps required changes in regulations and laws make it impossible to immediately get to the target situation. It may be easier to immediately issue the loans but make them convertible, at the government's option, to preferred stock when the preferred stock is issued and regulations have been adjusted appropriately. It is obvious that we do not understand all the legal details but we are sure that the army of lawyers sitting at home (or their ski lodges, or

their beach houses, or wherever) can find some path that requires minimal changes in laws and regulations and can be quickly implemented.

The big advantage of the preferred stock approach is that each corporation faces the same menu. No special deals for cruise lines, for hotels, or other industries that claim special circumstances. Perhaps we will eventually agree that some industries deserve special treatment but that can wait. The task now is to avoid unnecessary business failures. Later we can decide on burden sharing.

Criticisms

This proposal addresses only the problems faced by publicly traded corporations. There is nothing in this proposal that directly addresses the financial challenges of small businesses or of the millions of workers who are facing substantial loss of income. It is a political fact that government aid to corporations will get high priority. There are two advantages of this proposal: it is simple and transparent, and it will likely produce revenue for the US government to cover the costs of aiding the rest of the economy.

Conclusion

There will be massive financial aid to businesses. In the case of publicly traded corporations, existing institutions and financial instruments can be used to accomplish the key objectives: give the corporations the liquidity they need but do so on terms that do not cause more liquidity problems in the future, steer the funds to the firms with the greatest needs, do not lead to any kind of nationalization of industry, does not create a long-run drain on increasingly scarce US government resources, and reduces political conflict.