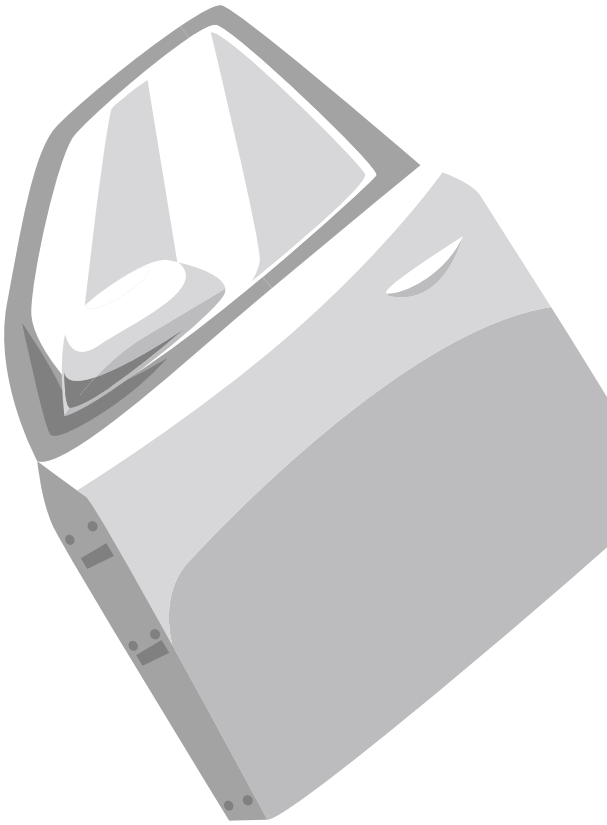

CHAPTER 1
Introduction

A. Changes in the Automotive Industry: 2006-12

In 2006, when the first edition of this work was published by the American Bankruptcy Institute,[1] the chapter 11 cases commenced by Delphi Corp. and a number of its affiliates were in full swing, along with the cases of a number of other Tier One and Tier Two automotive suppliers. At that time, no one could accurately predict the sea changes that would inundate this industry within the following three years, culminating in the federal government's bailouts of General Motors Corporation and Chrysler Corporation in late 2008, followed by their chapter 11 filings less than a year later.[2] The third member of the "Detroit Three," Ford Motor Co., declined to accept

1 *Auto Supplier Insolvencies & Bankruptcies: Issues for Suppliers and Customers of Financially Troubled Auto Suppliers* (ABI, 2006).

2 For a detailed description of the General Motors and Chrysler chapter 11 cases and their backgrounds, *see*, *e.g.*, Steven Rattner, *Overhaul: An Insider's Account of the Obama Administration's Emergency Rescue of the Auto Industry*, (Houghton Mifflin Harcourt Publishing Company, New York, 2010); Bill Vlasic, *Once Upon a Car: The Fall and Resurrection of America's Big Three Auto Makers* (Harper Collins, New York, 2011); and Paul Ingrassia, *Crash Course: The American Automobile Industry's Road from Glory to Disaster* (2010).

monies from the U.S. Treasury Department's Troubled Asset Relief Program (TARP) and subsequently performed its own internal financial and operational reorganization.[3]

A "new" General Motors and Chrysler emerged from their chapter 11 cases, which were orchestrated by the U.S. government, as stronger, slimmed-down original equipment manufacturers (OEMs), having shed redundant assets and, in Chrysler's case, operating with a new controlling shareholder, Fiat S.p.a., headquartered in Turin, Italy, and run by the dynamic Sergio Marchionne.[4] The 2008–09 world financial crisis also severely impacted the European automotive sector, where the ownership of General Motors' former subsidiary, Saab Automotive AB, was transferred to a Dutch car manufacturer, Spyker Cars, N.V., after commencing a reorganization proceeding in Sweden.[5] General Motors came within a whisker of selling its equity interest in its German subsidiary, Adam Opel GmbH, to a Canadian/Austrian/Russian consortium in late 2009 before abruptly changing course, deciding instead to retain ownership of Opel and its English sister company, Vauxhall Motors.[6] During this same period, Ford divested itself of its foreign subsidiaries, Volvo Cars, Jaguar Cars and Land Rover, by selling them to foreign OEMs.

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3 For the story of Ford's decision to forego TARP monies and bootstrap its own restructuring without invoking the aid of the bankruptcy courts, *see*, *e.g.*, Bryce G. Hoffman, *American Icon: Alan Mulally and the Fight to Save Ford Motor Company* (Crown Business, New York, 2012); Gerhard Geyer, *Ford Motor Company: The Greatest Corporate Turnaround in U.S. History* (2011).

4 *See In re General Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009); *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), *aff'd*, *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009), *cert. dismissed*, 130 S.Ct. 41 (2009, *cert. granted*, *judgment vacated*, 130 S.Ct. 1015 (2009), and *judgment vacated*, 592 F.3d 370 (2d Cir. 2010); *see also* Jennifer Clark, *Mondo Agnelli: Fiat, Chrysler and the Power of a Dynasty*, John Wiley & Sons Inc., Hoboken, New Jersey (2012).

5 Associated Press, "Spyker Completes Saab Acquisition," *Boston Globe*, Feb. 24, 2010, www.boston.com/business/articles/2010/02/24/spyker_completes_saab_acquisition; Patrick E. Mears, John T. Gregg and Mathias Winge, "The Saab Reorganization in Sweden: The Expedited and Successful Restructuring and Sale of a Global Automobile Manufacturer," www.lexisnexis.com/community/bankruptcylaw/blogs/bankruptcycommentary/archive/2009/11/02/The-Saab-Reorganization-in-Sweden_3A00_-The-Expedited-and-Successful-Restructuring-and-Sale-of-a-Global-Automobile-Manufacturer.aspx.

6 *See*, *e.g.*, Patrick E. Mears, Nickolai Wolff & Frank Heerstrassen, "Opel, European Union State Aid and Insolvency: The Negotiations by GM to Spin Off Opel," www.lexisnexis.com/community/bankruptcylaw/blogs/freedownload/archive/2010/03/23/free-download-opel-european-union-state-aid-and-insolvency-the-negotiations-by-gm-to-spin-off-opel.aspx.

As of June 2012, the global automotive industry, except for the European sector and, to some extent, the Asian sector, appears to have weathered the worst of the world financial crisis. The Detroit Three, after disposing of substantial automotive manufacturing and assembly assets and shrinking their workforces and supplier bases, seem to have right-sized their respective North American operations to adjust to reduced consumer demand for their products in this region. In addition, the Detroit Three have eliminated a number of vehicle platforms, focusing on fewer, more common platforms for use throughout the world in a reduced number of vehicle models. These measures, forced upon the Detroit Three by the crisis, have had the positive result of right-sizing their design, manufacturing and assembly costs, which have resulted in these OEMs reporting substantial profits from their North American operations in the first quarter of 2012—marking a complete turnaround from the bleak conditions of 2008–09.[7] The Asian automotive industry (and particularly sales of imports from Asia), however, continues to suffer from recent setbacks related to quality-control issues and the catastrophic tsunami that devastated Japan's northeast coast in March 2011.

B. Challenges Caused by Overcapacity in Europe

The major challenge that the Detroit Three and many foreign OEMs face in the immediate future arises in Europe. That continent's foreign and domestic automobile manufacturers must soon address the overcapacities that plague their operations and result in substantial operating losses. From 2008-12, the Detroit Three closed 13 factories in the U.S. and, by shifting production from the closed factories to other facilities, increased the use of their North American operational capacities from 66 percent in 2008 to 82 percent during the first months of 2012.[8] From 2007-12, the U.S. automotive industry, including transplants, reduced its overall capacity by 1.5 million units.[9]

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7 *See*, *e.g.*, Jerry Hirsch, "GM Quarterly Profit Falls on Losses in Europe but Tops Estimates," *Los Angeles Times*, May 3, 2012, www.latimes.com/business/money/la-fi-mo-gm-quarter-earnings-20120503,0,6880238.story; Chris Haak, "Chrysler, Ford Show Strong Financial Results," April 27, 2012, www.autosavant.com/2012/04/27/Chrysler-ford-show-strong-financial-results.

8 Automotive experts estimate that in order to break even on their manufacturing costs, factories must operate on at least an 80 percent capacity.

9 *See*, *e.g.*, Jack Ewing, "In Europe, Auto Overcapacity Gives Leaders Another Stubborn Issue to Ponder," *New York Times*, page B2 (March 8, 2012); "Ailing Carmakers Seek

In contrast, only three automotive plants in Europe were shuttered during the period from 2008 through early 2012, although more have been scheduled for closure later in 2012. In Europe, there are currently 241 automotive plants in 27 countries. During the world financial crisis, a number of European governments took actions to prop up their automotive industries by promoting scrappage schemes to subsidize purchases of new vehicles, often referred to as the "cash for clunkers" program. Few, if any, efforts were made during this period by these same governments to address the core issue facing Europe today: how to reduce automotive production capacities without tearing further the broad safety net, the *Rettungsschirm*, that protects European autoworkers and their families.[10]

The European automotive industry is now being forced to address this problem of overcapacity, and a number of European OEM executives, such as Sergio Marchionne and PSA Peugeot Citroen's Phillipe Varin, have become vocal on this issue. In order to partially address the problem, General Motors and Peugeot announced in early 2012 the creation of an alliance between the two OEMs for shared production that is aimed at reducing costs.[11] After declining to sell its Opel subsidiary in 2009 to a multinational consortium that included Magna International, General Motors has since continued to experience severe financial losses caused by its European unit (which includes the English Vauxhall brand). In an effort to stem these losses, Morgan Stanley recently recommended that General Motors market and sell Opel to a third party.[12]

The industry is feeling the heat of this drag on its overall profitability. In 2011, 13.1 million new automobiles were sold in Europe, which marked the fourth straight year of declines, and in 2012, industry experts anticipate an even lower sales volume. The economies of a number of European countries, including Spain and the United Kingdom, are in recession and, with the Greek financial crisis coming to a head, there is a remote possibility that the Eurozone may face a breakup, with some peripheral countries in crisis reverting back to

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Europe-Wide Overcapacity Fix," Thompson Reuters, March 7, 2012, www.reuters.com/assets/print?aid=USLE8E755Q20120307; Bertel Schmidt, "European Overcapacity: Marchionne Knows How to Fix It," http://thetruthaboutcars.com/2012/03/european-overcapacity-marchionne-knows-how-to-fix-it/.

10 *Id*.

11 *Id*.

12 Nathan Bomey, "Opel Called Top Threat to GM's Stability," *Detroit Free Press,* Page 1A, col.6 (Sept. 7, 2012).

their prior national currencies. In this automotive sector, the perfect storm that hit the Detroit Three so hard a few years ago may yet arrive on Europe's shores.

C. Broader Scope of this Treatise

Finally, the scope of this work has been expanded in this edition to address not only the automotive industry but also other industries that rely on supply chains that are sensitive to the financial stress or failures of any members of these chains. Many of the businesses in non-automotive supply chains have adopted the Toyota Production System, or "TPS,"[13] or some other "lean production" variant, and a number of these companies operate with a "just-in-time" inventory supply.[14] Thus, any substantial delay caused either by financial problems up the supply chain or even by other, unforeseen interruptions in the supply of needed raw materials or manufactured components[15]

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13 For an explanation of the Toyota Production System developed by Toyota in the 1970s and 1980s, *see* Jeffrey K. Liker, *The Toyota Way: 14 Management Principles from the World's Greatest Manufacturer* (McGraw-Hill, New York, 2003). One author describes TPS as follows:

> This method aims to improve product quality and profitability through creative employee contributions. Also a signature formula for lean production, in which waste is minimized and efficiency maximized, TPS is widely viewed as Toyota's distinct advantage in the competitive global marketplace. At the heart of TPS are standardized processes that encourage individual contribution to unified goals and objectives.... Based on Toyota's decades-long commitment to *kaizen*, on the daily and ongoing process of continuous improvement through the elimination of waste (*muda*) in the workplace, TPS has become essential to Toyota and other companies throughout the globe.

David Magee, *How Toyota Became #1: Leadership Lessons from the World's Greatest Car Company*, pp. 25-26 (Penguin Group (USA) Inc., New York, 2007).

14 On lean production methods of manufacturing, *see generally* Pascal Denis, *Lean Production Simplified: A Plain-Language Guide to the World's Most Powerful Production System* (CRC Press, Boca Raton, Fla., 2d ed. 2007); John W. Davis, *Progressive Kaizen: The Key to Gaining a Global Competitive Advantage* (CRC Press, New York, 2011).

15 An explosion on March 31, 2012, at the Evonik Industries chemical plant in Germany caused an unexpected global shortage of cyclododecatriene (CDT), which is used widely in a nylon present in coatings and connector applications in motor vehicle fuel-injection and braking systems. In response, automobile OEMs and their suppliers held an emergency meeting in Detroit on April 17, 2012, to address this unanticipated shortage of the critical resin. The *Financial Times* reported that this

> bottleneck highlights the negligible margin for error in the global car supply chain, which is running on lean inventories three years after the industry's worst crisis in many decades. Last year's earthquake

can stall and shut down the operation of supply chains, thereby resulting in large economic losses for all chain members. The authors hope that this book will appeal to and assist a broad audience of readers in their efforts to mitigate and solve the sometimes-knotty legal issues that arise in this context.

D. Major Risks Caused by Supplier Bankruptcies

1. For Customers

The worst nightmare for a customer such as an OEM or a higher-tiered supplier is the shutdown of a production line. Shutdowns can result in catastrophic damages being suffered by the owner of the line; workers are idled without notice, and parts and vehicles scheduled for delivery are stalled in various stages of production. Because the auto industry has adopted the "just in time" inventory delivery methods, higher-tiered suppliers and OEMs do not normally maintain large inventory banks to protect against a shutdown. This risk is exacerbated when a supplier to these fabricators up the supply chain is a "sole source" supplier. It may take a customer of a sole source supplier months to resource the parts that the customer is purchasing from that supplier, which means that the financially troubled supplier must be kept operating to supply these parts pending the customer's resourcing of the threatened part.

Several courts have recognized the severe economic consequences to customers of financially troubled suppliers from a line shutdown. One such example is described by the U.S. Bankruptcy Court for the Western District of Michigan:

> Because [Debtor] was a "single source" supplier to General Motors Corporation (among others), it feared that any interruption in its production schedules might result in a shut down of certain assembly lines while GM and

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in Japan and floods in Thailand wreaked havoc on some carmakers' production by causing shortages of semiconductors, paint pigment and other parts.

John Reed and Chris Bryant, "Carmakers Rush to Counter Supply Threat after Resin Plant Explosion," *Financial Times*, p. 13, col. 2 (April 18, 2012).

> other customers obtained new suppliers and made the necessary arrangements for new production tooling and dies. In turn, these shut downs might cause the layoff of innumerable employees of GM and Debtor's other customers.... The Debtor calculated that a shut down of a GM assembly line could result in a damage claim by GM and an offset against outstanding GM accounts receivable in excess of $9 million per day.[16]

Not only may a line shutdown result from the cessation of business by a sole-source supplier because of its financial problems, but a shutdown may also be caused by a strike called by the supplier's employees. The Norris-LaGuardia Act[17] prohibits federal courts from enjoining labor strikes or strike-related activities except in very narrow circumstances.[18] The effect of a possible labor strike on the integrity of production lines continuously raises substantial concerns for customers and OEMs. For example, the last UAW strike against General Motors in 1998 at two parts factories in Flint, Mich., forced the closing of GM's 29 North American assembly plants, cancelled production of 318,000 vehicles and cut GM's profits by $1.3 billion.[19]

2. For Other Suppliers

Perhaps the most serious consequence of a higher-tiered supplier bankruptcy to its vendors is the domino-like effect that the bankruptcy might have on those vendors, much like the mid- to late 2000s in the automotive industry, when it was predicted that the bleeding would occur from the "bottom up" as opposed to the "top down." In the event that a bankrupt supplier substantially reduces the volume of its purchases from its vendors, switches suppliers or liquidates, the cash flow of these vendors will consequently suffer. In addition, if these vendors obtain working-capital financing on the basis of advances made under borrowing bases, their lenders may

16 *In re Autostyle Plastics Inc.,* 216 B.R. 784, 788 (Bankr. W.D. Mich. 1997); *see also General Motors Corp. v. Paramount Metal Prods. Co.,* 90 F.Supp.2d 861 (E.D. Mich. 2000); *Kelsey-Hayes Co. v. Galtaco Redlaw Castings Corp.,* 749 F.Supp. 794 (E.D. Mich. 1990).

17 29 U.S.C. §§ 101-115.

18 29 U.S.C. § 107; *see also* Note, *Workers' Rights Against a Bankrupt Employer,* 26 Wm. & Mary L. Rev. 545 (1985).

19 Bloomberg.com, "GM Cash Reserves May Be Drained if Delphi Strikes, Analysts Say" (Nov. 17, 2005).

require that the receivables from the bankrupt supplier be disallowed as eligible receivables against which advances can be made. This effect will further constrict the vendors' cash flow. If the financial exposure of these vendors to the bankrupt supplier is large, the subsequent impact on the vendors' cash flow may result in subsequent bankruptcy filings by vendors that cannot absorb these losses.