

region to region. When the Spanish market matures, Clarence indicated that Italy was likely to heat up. He felt that the UK market would settle over the next year and he was unsure if interest would ever fully ignite in the Greek market. Once all matters had resolved, the cycle would most likely start over again. Johannes Bitter-Suermann said he felt that there would be no winners, no losers and no blood-bath and Juan Amigó Müller said that there would be deals but he did not believe there would be a crash in prices and that the market would become steadier over time.

Conclusion

In summary, this was an extremely lively and entertaining discussion on a very worthy and relevant topic. In particular, the panel spoke openly about the finance tools and concepts that had given rise to the global financial crisis and the unprecedented amount of distressed loans and real estate in the current market. By way of reassurance, the panel appeared to be of the combined view that although this financial

crisis has been extremely brutal and prolonged it was nonetheless part of a continuing economic cycle. Although much of the session revolved around the position in relation to European real-estate, the reason for that is there is a significant amount of distress across Europe at the moment. It was clear from the talk that distressed loan and real estate investment must be viewed from a global perspective with the relevant players moving from market to market as the environment changes over time. Whilst at present the main investment players are coming in to Europe from other continents, when the European markets improve no doubt the cycle will reverse.

There was an overall consensus that little had been learnt from the global financial crisis and that similar mistakes were being made again already. As a rule of thumb it was observed that ‘the corporate brain is washed every three years’, which brings to mind a suitable (German) quote to conclude upon:

‘We learn from history that we do not learn from history’
(George Wilhelm Friedrich Hegel)

When the car runs out of gas: restructuring in the European automotive sector

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Setting the context

To say that any sector has remained unscathed by the recent global financial crisis is truly a myth. One sector quite familiar with the effects of the recent recession is the automotive sector. From as early as mid-2007, the purchase of vehicles began to decline sharply from 15.6m to 12m annually, a decrease of 23 per cent.¹ This reflected the reality that the economic climate affected consumer vehicular investments.

In the South Western European area (Greece, Italy, Spain and Portugal), a trilogy of challenges arose for car production and sales. First customers, who would usually retain their vehicles for no more

than five years, now decided to retain them for up to seven years, resulting in a decline in car purchases of eight per cent between 2007 and 2014. Second, many of the original equipment manufacturers (OEMs)² discovered offshore production. Therefore greater levels of production was seen in the BRIC countries (Brazil, Russia, India and China), with Romania and Thailand now developing. Statistics showed that OEMs located onshore in Europe (France, Spain and Italy) were not growing. This directly affected employment in the European automotive industry. Until 2008 production of light commercial vehicles (passenger cars and minivans) was consistent. However, after that date,

in line with the financial crisis, there was a continual average decline of 42 per cent. This severely affected employment and union-related issues reached a peak. In most car producing states, production dropped from seven days a week to a few days. Even more severe were the effects felt by upper mid-sized saloon (or sedan) cars, where a decline in consumption by 70 per cent reduced the working week to one day. Issues of retention of skilled employees often means that highly skilled workers were assigned comparatively menial tasks such as security. The direct links (and effects) between the automotive industry and employment have been considered by the International Labour Office in 2010 Report *The Global Economic Crisis: Sectoral Coverage – Automotive Industry: Trends and Reflections*.³

Third, the boom in car sales pre-2007 resulted in the entrance of many new OEMs or suppliers in the market. This increased supply met with decreasing demand has added to the catastrophic effects felt in the automotive industry.

Having set the context in the automotive sector in the post-financial crisis period, it is critical to consider the deeper trends. It is well established that external economic factors resulted in the sector's decline, however, attention is often not paid to the internal reasons for the decline of the automotive sector. At the heart of the article, a discussion on the internal reasons for insolvency in the automotive sector will be complemented by a consideration of tools in legislative toolboxes critical to the recovery of the automotive sector. Special focus will be placed on the legislative developments in Spain and Germany, which may serve as pioneers for reform in other jurisdictions. This conference report will conclude by looking ahead. What future challenges face the automotive sector? Are any solutions on the horizon?

Current trends in the automotive sector

In tandem with the global financial crisis, there are five trends that assist in a clear and comprehensive understanding of the true state of the automotive sector. The order of discussion should not be interpreted as a barometer of their relevance.

Trend 1: Movement of production

One of the trends in the European market is the movement of production. In some cases, production remained in Europe but has been moved to Central and Eastern Europe where production increased by four per cent every year (twice as fast as Western Europe). However, in a significant number of cases, production

has been moved off the continent to the Indian, Asian and Latin American continents. In the article *Challenges for the automotive industry in an on demand environment: Seven areas of strategic action*, a consulting firm suggests that states in Latin America (such as Argentina and Brazil) are usually an OEM's least priority approach as the markets are very volatile whereas Eastern Europe is preferable due to its much higher and sustainable growth potential.⁴ China continues to a viable market for the establishment of OEMs; however, given fears about the unpredictability of government regulation along with the overcapacity evident as a result of reduced demand stemming from the global financial crisis, OEMs are hesitant about entering this market.

This move to offshore production has been prompted by the high production costs associated with manufacture in Western Europe. However, manufacturers have argued that this move is not simply pre-empted by 'cheaper labour' and government incentives which would ensure continued viability of the company as a whole but rather a range of benefits accorded to offshore production. These include lower taxes, lower operational costs, lower shipping and surface transport costs; all of which will lead to price stability. This is one of the proposed solutions to return stability to the automotive sector as it attempts to 'heal from the wounds' inflicted in the post-2007 period.

This reality was documented by Forbes recently:

'The Hungary division of Audi, Volkswagen's luxury brand, manufactures the entire lineup of Volkswagen vehicles as well as produces the new compact sedan A3 in the Győr plant. The production capacity at the Győr plant rose to 125,000 units, from less than 35,000 units manufactured in 2012. In addition, Skoda, which saw sales rise 26.2 per cent in the major Central European markets in May, is also expanding its plant in Kvasiny, Czech Republic, to produce a large new sports utility vehicle. The successor model to the Volkswagen Transporter and Crafter will be produced in Poland, after the collaboration between Mercedes and Volkswagen for manufacturing these commercial vehicle models ends in 2016. For this purpose, a plant will be built at Wrzesnia, Poland, providing 2,300 jobs.

'On the other hand, Daimler is also looking to outsource production activities from Germany to countries with lower labor costs. The company expanded its production activities in central and eastern Europe in 2012, with production of compact luxury cars Mercedes B-Class and CLA-Class at the Hungary plant which employs 3,000 workers. Daimler's Mercedes has only four production locations outside Europe and 11 locations within Europe, with Germany being the major manufacturing site. While overall vehicle production in Germany rose by only 1.2 per cent,

production in Romania and Hungary combined grew by 14 per cent in 2013. However, Germany still manufactures almost five times the number of vehicles produced in Romania, Hungary and Poland combined. Higher production in low-cost central and eastern European countries could boost profitability for the automaker. Mercedes' operating margin stood at 7 per cent in the first quarter of 2014, trailing Audi's 10 per cent. In addition to expanding production in China and Brazil, shifting operations to central and eastern European countries with lower wages might increase profits for Mercedes, going forward.⁵

Unfortunately, companies have lived to tell the sad tale that the oft forgotten flip side of offshore production is a possible reduction in product quality. Given the resources expended, employees in Western Europe are said to have a superior knowledge in the maintenance of quality standards. However, offshore production does not equate to 'death' for quality assurance. Rather companies must continually invest resources in new production areas through training and, where necessary, relocate high-quality employees offshore.

Trend 2: Extreme competition

In the pre-2008 period, the automotive sector was flooded with OEMs. However, the fall in demand in the post-2008 period meant that many of these OEMs were forced out of the market. Whether an OEM withstood the competition created by increased suppliers with reduced demand was dependent on two factors. First, the jurisdiction in which the OEM was located. This is further discussed below where consideration is made of the exorbitant spikes in interest rates in specific jurisdictions. Second, the success was often dependent on the specialisation of the OEM; in some cases, those who were too highly specialised were forced out of the market due to reduced demand for high-end products.

Trend 3: Rising interest rates

Given the prevailing economic climate, financial institutions have proceeded with much caution before releasing any form of funding. Further, the frequency of announcements on bankruptcy and distress in the US automotive market did nothing to restore loss confidence in the viability of this sector. Slowing growth in Europe in this sector exacerbated this state of affairs. All of these factors led banks to the unmistakable conclusion that lending to this sector was highly risky. This resulted in spikes in interest rates, creating high rates of default across companies, OEMs and suppliers.

For small and medium enterprises (SMEs), the increase in the cost of capital over the crisis period

was highly significant. In Portugal alone, interest rates spiked 47–50 per cent. Quite obviously, in the face of declining revenues this increase would be difficult to absorb and would often lead to collapse. Given the interrelationships between companies, suppliers and OEMs (among others) and the high reliance on debt, this collapse would create ripple effects across the sector, as companies would be inhibited from serving their debt. The extent of interest rate spikes was often jurisdiction-dependent: in Italy, the average spike was about 30 per cent while in Spain an average spike of 20 per cent was recorded.

The major implication of this spike is that it continued to threaten the stability of that sector. In the absence of the spike, companies were already unable to effectively service their debts due to declining revenues. Thus, in the face of spikes, businesses were unable to grow. With no business growth, there could be no resulting economic recovery. In recent times, cries have been made to implement legislation to address this unsatisfactory state of affairs.

Trend 4: Car sharing

One of the trends affecting the sale of new passenger cars is the advent of car sharing. In the past, car sharing was synonymous with car-pooling where an existing car owner would offer a ride to individuals who travel on the same route. However, this phenomenon is fast developing where companies such as BMW have teamed up with other agencies to offer a service where the user is not the owner of the car and does not bear the financial burden associated with a car purchase. Services such as Car2Go (sponsored by Daimler in collaboration with Europcar) and DriveNow⁶ (sponsored by BMW in connection with Sixt) have been transforming how individuals use vehicles, where customers pay per minute of use and leave the car in any legal parking space when they are finished. This increased flexibility (in particular, absence of a requirement to return the car to a specific location) means that customers are not required to plan their journey with an established destination (the agreed location in which car must be returned).

Trend 5: Alternative means of transport

With the cost of new cars beyond the reach of many customers, there has been an increase in the sale of other forms of transport. Of particular interest is the bicycle. Data compiled by NPR shows that in 2013, bicycle sales exceeded car sales in 23 European states for the first time in Europe's history, with the exceptions of Luxembourg and Belgium.⁷ Apart from the added

convenience afforded by bicycles and initiatives to promote cycling as a healthy and environmentally better option, other factors may be drawing European households away from cars. It appears that when compared to a bicycle, the cost of a car is prohibitive.

Country	Bicycles sold ('000)	Passenger cars ('000)
States with larger demand		
Germany	3,966	3,083
Britain	3,600	2,045
France	2,835	1,899
Italy	1,606	1,402
Spain	780	7,00
States with smaller demand		
Romania	380	72
Greece	320	58
Slovenia	250	50
Hungary	232	53
Lithuania	115	12

Table: Comparison of European new passenger car and bicycle sales (2012)⁸

Down the slippery slope: main internal reasons for insolvency in the automotive industry

There are a plethora of reasons for failure of corporate entities in the post-financial crisis period; many of which relate to the changing economic climate. These may be properly regarded as external factors. However, this section discusses the main internal reasons for insolvency in the automotive industry.

First, there was a loss of customer confidence due to outsourcing. Many of the companies outsourced to China where wages were up to 30 per cent cheaper. However, this comparable saving often resulted in a loss of quality which rippled into a loss of customer confidence, who would, in turn, blacklist the companies. This resulted in loss of revenue. Second, due to previous pressure from companies, many of the OEMs produced on a large scale. However, they were unable to scale their production to reflect the reducing demand due to the economic crisis. Third, as discussed above, the bank's financial condition in the post-crisis period led to a hardening in the allocation of finance and spikes in interest rates.

Fourth, there was a high potential for leakage of intellectual property. Given that the OEMs had

extensive knowledge on the production of the particular brand of vehicle, the leaking of any sensitive information may have contributed to the demise or reduced profitability of the company. The company may have been required to pay exorbitant costs to secure this information. Fifth, extensive power was held by raw material suppliers. Though OEMs played a dominant role in the automotive sector in many European countries, the supplier often held the controlling power as it determined the decisive issue of ownership of tools. Where the supplier was large, it often held a strong veto in the out-of-court restructuring. Delays in this regard contribute to the demise of a company in a fragile financial position. To buffer against this reality, companies often engaged more than one supplier; as a lack of concentration in the supply chain meant that the supplier does not have as much power over the company. This reality has blossomed into the current practice where the company owns the tools and lends them to the OEMs. Thus, going forward, the recovery of tools should no longer pose difficulties.

The final two considerations are the most intensifying points going forward relative to internal reasons for insolvency. First, it is well established that highly skilled employees are often regarded as crucial to the rise or fall of a company and thus, in insolvency, efforts are often made to transfer the services of the employees. (Issues will often arise where employees are often retained on less favourable terms.) Given the high specialisation required, whether at supplier or OEM level, the skill in producing and assembling the parts is integral to the production of high quality vehicles. When production was moved east, many of these already well-trained and educated employees who assisted in ensuring standard-compliance were lost. It is well accepted that the access to high-quality employees may not pose an issue where production plants are located in the United States or Western Germany (due to prior investments in training). However, the desire to cut cost to provide a more affordable vehicle means that this is slowly proving to be a problem in Russia, China and Korea. The issue of training and treatment of employees will remain topical until many of these issues have worked themselves out in practice.

The second topical issue relates to the challenges posed by in-court and out-of-court restructuring (due to antiquated legislation or legislation which is not sector-specific or sector-adaptable). One of the inefficiencies relative to the automotive sector which is often highlighted relates to time. In Spain, a minimum of two to three weeks elapses before the declaration of insolvency and the subsequent appointment of the insolvency administrator are made. Though this may be negligible in some sectors, in the automotive

sector, challenges will arise where this extensive delay will facilitate the disappearance of tool as ransom for pending payment. By the end of one week, all of the assets may have already been stolen, leaving the business as no more than a shell.

Legislative toolboxes for turnarounds: key developments aiding the automotive sector

Knowledge of developments in the legal framework across Europe are critical for both debtors and creditors, particularly where such creditors may be situated outside of the jurisdiction. Within the last two years, the legislation in a number of jurisdictions has shifted its focus to rescuing of the company or business, rather than outright liquidation. Focus will be placed on two jurisdictions that have recently enacted key reforms: Germany and Spain.

Germany

On 1 March 2012, the Bundestag enacted a range of reforms to German insolvency laws known as *Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen* (ESUG). Under the old law, the insolvency judge appointed a provisional insolvency administrator (IA). From this point, unemployment insurance covered wages for the next three months. During these three months, the insolvency administrator would recommend to the court whether he believed that the case should be opened. If so, he usually presented the name of a willing buyer to the court and the case would end with a sale of the assets similar to section 363 of the Bankruptcy Code. The insolvency administrator is paid a percentage out of the estate based on his return to creditors. There were four effects of the old law:

- There were hardly any debtor in possession (DIP) cases;
- There were hardly any reorganisations;
- The procedures under the law were efficient at saving business but ineffective in saving company; and
- Due to the inefficiencies created under the regulatory framework, many of these cases were moved to the United Kingdom.

Under the new law, on the satisfaction of certain financial and employment criteria, the court must appoint a creditors' committee. Then, this committee would propose a candidate for the position of insolvency administrator. Thus, under the new law, the court appoints an insolvency practitioner on recommendation from the stakeholders unless the court is given just cause as to why that person should not be permitted to act in this capacity. During this period, the company is given a three month protected screen

where the debtor company and the creditors work out a solution. Given the frequency of DIP under the new law, the court also appoints a trustee whose role is quite limited in contrast to the insolvency administrator.

There are four developments:

- Reorganisation (whether by sale of assets but also of legal entity) has been promoted;
- There is an increase in the influence of the creditors (via the creditors committee which proposes the insolvency administrator);
- There has been a drastic increase in DIP cases for the reform expressly permits the debtor to stay in charge. It should be noted that this was theoretically possible under the old law but was never applied in practice. The difficulty, which arose in Germany, related to a skewed understanding of the DIP concept. What was believed was that DIP meant that the same management team that led the company to its demise would be permitted to remain in control. Rather, a proper understanding would lead to the fact that stakeholders should agree on who should be appointed as restructuring offers and carry out this restructuring with the new team. Here, the debtor, through the will of the stakeholders, is in control.
- The insolvency plan may now include debt-to-equity swaps. These changes, particularly where the stakeholders have a say in the appointment of the insolvency administrator, are fundamental and for the benefit of restructuring entities. However, German courts are reluctant to administer the new law given their compulsion to appoint on the recommendation of stakeholders, which has now fettered their discretion.

It is clear that this reform will inure to the benefit of restructuring in the automotive sector. However, given the fact that the reform is less than five years old, it is too early to give a final assessment. What is clear is that the influence of the customer is very large and that it is the customer and not the OEM, IA or court which makes the decisions. Despite the fact that it is too early to assess, the court's treatment of future insolvency cases in the automotive sector is guaranteed to add fuel to an already live debate.

Spain

On 7 March 2014, the Spanish Council of Ministers reformed Spanish Insolvency Act 22/2003 to facilitate greater corporate debt restructuring by approving Royal Decree Law 4/2014. Under this new framework, the debtor has an initial two months to contact creditors and determine a composition agreement. When a petition for insolvency is made, the courts will often take two to three weeks to grant a declaration of

insolvency. When this is filed, the law permits the debtor to continue to run the business as it is believed that he is the best person as his knowledge of the business is superior; however, an insolvency administrator is usually appointed to serve in an oversight capacity.

Such an individual serves a number of roles which include supervising the running of the business by the debtor, preparing a preliminary report (eg, classifying claims and creating inventory of assets) and reviewing actions during what is called the 'suspicious period' (also called 'clawbacks' or 'reviewable transactions' in other jurisdictions). Where the company's rescue is unsuccessful, he must classify the insolvency as negligent or fraudulent. This classification raises the possibility of liability for directors and other stakeholders. One of the latest reforms was the provision of an automatic stay. This protection from compulsory and enforcement proceeding is a critical tool where rescue is a desired goal.

Under the legislation, there are three solutions provided for a troubled company:

- liquidation;
- composition agreement (continuity of the business); and
- sale of the business unit.

Under the composition agreement, there is a possibility of a haircut of up to 50 per cent; however, in practice, creditors usually take a haircut of up to 65 per cent. One of the most important features of this agreement is that a creditor or creditors holding 50 per cent of original claims acquire the legal majority to make decisions.

As it relates to the sale of the business unit, it should be noted that 93 per cent of insolvency proceedings usually end in liquidation. Within the last few years, the trend is to keep the business alive but to close the company by the sale of the business unit. This is preferable as the new owner does not have to take all or any of the assets or any of the employees and no liabilities are transferred including taxes; thus, the acquisition provides assets that are free of charge. The possibility of securing such assets is inviting to banks. However, one of the key problems that have arisen where the transfer occurs relates to the interim period as questions relating to the liabilities arising in the interim period often arise.

As it relates to the impact of Spanish insolvency on the automotive sector, two key elements are noteworthy. First, what happens when the insolvent supplier cannot afford to purchase the raw materials that are necessary for the manufacturing process? The present solution is the acquisition of raw materials by the company. Thus, if supplier became insolvent, the rights to the materials would remain vested in the company. The second issue

that often arose related to the retention of tools which are specialised for production by the company. Quite importantly, there is a provision in Spanish law that permits the court (on an application) to separate the assets from the company. In such cases, the court must be compelled that there is no right to use or retention of assets. Outside of the law, the company would simply justify ownership of the tools through negotiation. The problem arising was opposition in the delivery of the tools back to the owner. In practice, it has been found that this is best achieved by out-of-court negotiation as employees are often prone to hide or damage tools where they feel that they have been mistreated.

Going forward, in light of the reforms, there are three key unanswered questions. First, what can an automotive company do when its suppliers cannot buy the raw materials required in the automotive sector? (Possible solutions have been devised as discussed above; however, the law has not yet addressed directly this area of concern.) Second, how can a customer preserve the industrial process and prevent stoppage given the implications for other suppliers? Third, what can a customer do to receive moulds in the company without challenge?

Looking ahead: future challenges facing the automotive sector

Looking ahead, there are four major challenges which must be faced and countered to reduce the inefficiencies and increase the possibilities of a successful turnaround in the automotive sector. First, this sector must agitate for industry-specific legislation. Given the peculiarities within their sector, they must be able to present a range of options in their toolbox for legislative consideration as some solutions have been shown to be more efficient and favourable to certain sectors. In the interim, lawyers operating in this industry must carefully consider how inefficiencies in the out-of-court produced may be reduced (and possibly eliminated).

Second, as proven above, companies must accept (and adapt) to the changes in consumer behaviour. Given the shift from cars as the preferred mode of transport (due to financial burden, parking and congestion issues in large cities), car companies must adopt ingenious methods by which the customer's use their vehicles on convenient terms. Reference may be made to BMW and Daimler. Contingent on this point is the shift in generational trends; where the present generation is more interested in connectivity and evolving gadgets. This should not be seen as a hurdle but rather as an emerging customer-base who may be willing to invest where connectivity meets auto-manufacturing.

Third, companies must be willing to invest in newer forms of automotive technology such as electric or solar-powered cars. Where funding to finance such research is not forthcoming from a traditional lending institution, companies must access other sources of finance. Fourth, companies must accept that the inevitable result of the present overcapacity is consolidation in the automotive industry. In order to scale down production but remain viable, many smaller companies will have to sacrifice their individual identity through mergers. On the other hand, larger companies must now become specialists in their products and place greater focus on customer understanding and intimacy.

Indeed, the future may look uncertain for the automotive industry (whether at the supplier, OEM or company level) but the tenacity shown by many players in the automotive sector to continually adapt (both to changing customer needs and the economic climate) is credible evidence that their car is not out of gas!

Notes

- 1 The International Council on Clean Transportation, *The European Vehicle Market Statistics* (2013), 2 www.theicct.org/sites/default/files/publications/EU_vehiclemarket_pocketbook_2013_Web.pdf accessed 30 June 2014.
- 2 Advent of OEMs: 'As companies became multinational, many of the car companies identified that they could raise productivity by focusing on their core competencies. For the first time in the history of car manufacture, the production of vehicles was being outsourced to third parties. Dynamic players who were interested in using their resources to revolutionise the automobile world and meet changing customer demands soon filled this market; thus, the birth of original equipment manufacturers. Their goal was to dedicate their resources to a single customer (car company) so that their customer would have a competitive advantage over its competitors.' Source: *The Decline of International Electronic Manufacturing in Italy: What are Italian Companies Learning?*, www.e3group.eu/index.php/the-decline-of-international-electronic-manufacturing-services-in-italy-what-are-italian-companies-learning/ accessed 27 June 2014.
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- 8 Krishnadev Calamur, *In Almost Every European Country, Bikes Are Outselling New Cars*, *NPR*, October 24 2013, www.npr.org/blogs/parallels/2013/10/24/240493422/in-most-every-european-country-bikes-are-outselling-cars, accessed 24 June 2014.