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Takata: The unfortunate recall

David Conaway reports on the global effects of a major product recall, and the subsequent innovative application of the Section 363 auction



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The tragedy

Takata Corporation is a Japanese-based company that manufactures safety products, primarily airbags and seat belts, as a tier one supplier to the global auto industry. Unfortunately, due to alleged defective airbags produced, Takata has recalled reportedly 122 million airbags globally, with a projected cost of \$12 billion.

Takata's airbag recall is tragic because the airbags are allegedly responsible for over 15 deaths and over 150 accidents around the world, according to the December, 2016 reports by the *Wall Street Journal* and the *Bangkok Post*.

The economic loss

The Takata airbag recall has already caused enormous economic consequences to certain of Takata's stakeholders, including customers, lenders, investors and equity holders. The customers are mainly 19 automakers throughout the world including BMW, Ford, Honda and Volkswagen.

Honda is also one of Takata's major investors. An October 7, 2016 *Wall Street Journal* article reported that the recall burden of the automakers was Honda 47%, Toyota 21%, Nissan 11%, and all others 20%.

According to numerous media reports, the airbags recalled globally total 122 million, and the cost of replacement and repair totals approximately \$12 billion. Moreover, the U.S.'s National Highway Traffic Safety Administration ("NHTSA") issued a statement that the automakers have "ultimate responsibility" for the costs of replacing the airbags. NHTSA appears to be particularly

concerned about the risks of airbag explosions in older Honda vehicles made from 2001 to 2003. The U.S. Government will emerge as a material stakeholder, with Takata currently operating under a five-year, \$200 million consent decree with the NHTSA.

In addition to the \$12 billion of airbag replacement liabilities, Takata reported it has sustained a cash operating loss of over \$500 million since the inception of the recall in 2013. Moreover, Takata is facing civil and criminal fines and penalties from various government agencies, throughout the world. A number of class action lawsuits have been filed seeking redress from Takata for the tragic loss of life, personal injury, and property damage allegedly caused by the defective airbags.

As a result of the economic loss, the automakers will likely emerge as Takata's largest class of unsecured creditors. Takata supplied defective products to the automakers, which at a minimum creates claims for breaches of contract, for the \$12 billion of reported losses. It is not clear who, between Takata and the automakers, is paying the costs of the airbag recall, but it is a reasonable assumption that Takata is unable to absorb all of the costs, and that the automakers are absorbing a significant share.

There has been no indication that Takata is not paying its suppliers in the ordinary course of business. Faced with uncertainty, vendors often impose cash-before-delivery terms on its customers, to hedge against a potential loss should the customer file for insolvency protection, including a Chapter 11 filing. A material imposition of cash payment terms

for Takata will impact its working capital requirements and pressure its lenders and investors to cover this additional cost. The scope and ultimate loss for the class action lawsuits will not be known for some time. As with mass tort lawsuits generally, the number of plaintiffs is increasing as losses continue to occur and there will be future plaintiffs. Ultimately, there will be pressure to create a dedicated fund, or source of funds, to address these losses over an extended period of time.

Takata's corporate structure

Takata was started in 1933 in Japan primarily producing lifelines for parachutes and other textiles. Over time, Takata expanded into seat belts, child restraints, and airbags. To accommodate a world-wide auto industry, Takata expanded geographically, including in the U.S., Mexico, Brazil and Uruguay. In Europe, Takata has facilities in Germany, Czech Republic, Poland, Hungary, Romania, and Russia. In Asia, Takata maintains facilities in Singapore, the Philippines, Thailand, Malaysia, Korea, China, India and Indonesia.

Prior to the airbag recall which began in 2013, Takata had a seat belt recall in the U.S. in 1995 relating to about 8.5 million vehicles built from 1986-1991, which at the time was identified as the second largest recall in the 30 year history of the U.S. Department of Transportation.

The restructuring

Faced with the consequences of the impact of the airbag recall, in February, 2016, Takata's Board of Directors appointed a steering committee to explore solutions

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including a restructuring of its businesses. According to the *Wall Street Journal* on May 25, 2016, Takata engaged Lazard Ltd. to seek a cash infusion and negotiate with automakers over “the ballooning” costs, and to help craft a restructuring plan to deal with “billions of dollars” of liabilities. *Reuters* reported that the restructuring would focus on Takata’s Michigan-based assets, which account for one-half of Takata’s global sales. Takata’s Michigan-based entity is TK Holdings, Inc. Indeed, Takata also engaged the well-known New York-based restructuring law firm, Weil, Gotshal & Manges LLP to advise regarding a restructuring.

Numerous news reports including from *Reuters*, *Bloomberg* and the *Wall Street Journal* in the fall of 2016 indicated that Takata solicited bids from various strategic and financial buyers or investors with respect to certain of its assets, presumably primarily the U.S.-based assets. The reported bidders included Daicel Corp., Autoliv Inc., Bain Capital, Kohlberg Kravis and Roberts (KKR), Key Safety Systems, Inc. and Carlyle Group. On October 17, 2016, the *Wall Street Journal* reported that a joint bid of \$3.5 billion was made by Daicel and Bain Capital, which was one of five bids that cleared the first round of bids. Subsequently, based on November 16, 2016 *Wall Street Journal* and December 15, 2016 *Bloomberg* reports, the automaker-customers preferred a bid that included either Sweden’s Autoliv or Michigan-based Key Safety Systems, as automakers seek a partner with a track record of quality control and operations in major world markets.

Based on the continuous flow of news reports from reliable sources, it is clear that Takata is attempting to address the financial and other issues arising from its airbag recall. It is now clear that a restructuring is being considered, that would involve an investment or purchase of assets by a combination of financial and strategic buyers. The bidding process continues and on December 15, 2016, *Bloomberg* reported that the successful bidder may be named in the 1st quarter of



2017. Reportedly, all of the bidders’ proposals have included a U.S. Chapter 11 filing of certain of Takata’s U.S.-based subsidiaries. Undoubtedly, the bidders prefer a Chapter 11 filing to obtain the benefits and protection of Section 363 of the Bankruptcy Code, which generally allows a debtor to sell assets free and clear of liens and encumbrances to a third party buyer, with liens attaching instead to the proceeds of the sale. However, news reports indicate that Takata Corporation’s management expressed a preference to avoid a bankruptcy filing. One wrinkle of the Section 363 strategy is the recent U.S. 2nd Circuit Court of Appeals ruling in the General Motors case holding that “new GM” (the Section 363 purchaser) could be sued for faulty ignition switches made by “old GM” prior to its Chapter 11 filing. Perhaps bidders would be willing to pay less or require a purchase price holdback, to account for this potential risk.

Another interesting question will be, in the event of a Chapter 11 filing, would the normal Section 363 procedures be followed? The Lehman Brothers Section 363 sale to Barclays in 2008 clearly demonstrated a U.S. Bankruptcy Court’s willingness to flex the customary Chapter 11 procedures to accommodate business goals. Lehman Brothers was sold to Barclays, as the sole bidder, within five days after Lehman’s Chapter 11 filing, to avoid an apparent

meltdown of the global financial markets.

Normally in a Section 363 sale, a debtor procures a “stalking horse” bid that is subject to higher and better bids, and ultimately court approval. It appears that the “auction” may already be occurring and upon a Chapter 11 filing, a single-bidder Section 363 sale could be presented to the Bankruptcy Court. Takata could assert to the U.S. Bankruptcy Court that the Section 363 sale procedures and safeguards were in fact followed pre-petition, and provide evidence that the winning bid was indeed subject to rigorous marketing, negotiation and auction, albeit pre-petition, and that the highest and best bid is in the best interests of Takata’s estate and stakeholders.

Whether any non-U.S. Takata entities seek insolvency protection under foreign insolvency laws is far from clear. Thus, whether such Takata entities may also seek recognition of the foreign proceeding the U.S. pursuant to a Chapter 15 petition for recognition is likewise uncertain. It nevertheless appears somewhat likely that Takata’s U.S.-based entities will seek Chapter 11 protection in 2017 to address the economic consequences of its unfortunate airbag recall. ■

Note:

- 1 Takata Corp. is a limited reporting company in the U.S., thus financial and other information produced by the company is not available. Reliable business news sources including the *Wall Street Journal*, *Reuters*, *Bloomberg* and *Dow Jones* have frequently reported on the airbag recall, the potential losses and potential restructuring.



IT IS NOT CLEAR WHO, BETWEEN TAKATA AND THE AUTOMAKERS, IS PAYING THE COSTS OF THE AIRBAG RECALL, BUT IT IS A REASONABLE ASSUMPTION THAT TAKATA IS UNABLE TO ABSORB ALL OF THE COSTS

