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Global Supply Chains and Free Trade Agreements: A Suggested Vehicle for Harmonization of Insolvency and Contract-Enforcement Laws

By Patrick E. Mears, Christoph G. Paulus, and Shinjiro Takagi*

The authors of this article analyze global supply chains in the context of the Trans-Pacific Partnership and Regional Comprehensive Economic Partnership negotiations. One internal source of supply chain disruption is the business failure of a member caused by its insolvency or illiquidity. These disruptions cause economic losses up and down the affected chain and can exacerbate economic woes in the afflicted region. The authors suggest that nations include provisions in bilateral or regional free trade agreements requiring treaty signatories to enact insolvency or contract-enforcement remedies.

The ongoing Trans-Pacific Partnership ("TPP") negotiations involve 12 Pacific-Rim nations, viz., the United States, Japan, Australia, New Zealand, Canada, three Latin American countries (Mexico, Peru and Chile) and four East Asian countries (i.e., Brunei Darussalam, Malaysia, Singapore, and Vietnam). These negotiations have focused upon the development of global supply chains ("GSCs") in the region. Stated goals of the United States in these trade talks include encouraging GSC growth in the treaty states and to share in that development. A parallel negotiation, the Regional Comprehensive Economic Partnership ("RCEP"), involving the People's Republic of China, Japan, Australia, New Zealand, India, and 11 Asian countries, has also embraced the goal of fostering supply-chain development in the region covered by these talks.

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GSCs, which involve producers of goods engaged in the assembly of final products derived from various intermediate goods manufactured by chain members (*e.g.*, the assembly of an automobile from a large number of components and modules), have been experiencing dramatic advances in East Asia, powered primarily by the manufacturing "engine" of the People's Republic of China. Notwithstanding this recent and spectacular growth, supply chains, especially those that engage sole source suppliers who operate with "just-in-time" inventory systems, are extremely fragile and often grind to a halt when the chain's operation is disrupted by outside forces, *e.g.*, natural disasters or labor strikes that damage or hobble crucial infrastructure.[1]

One internal source of supply chain disruption is often overlooked by chain members: the business failure of a member caused by its insolvency or illiquidity. When a chain member that is contractually bound to produce and ship goods according to a strict schedule dovetailing with the schedules of other chain members, becomes financially unable to produce and deliver "intermediates" on a timely basis, the effect on the chain's operation is often immediate and dramatic. The chain's operation slows or stops for lack of "just-in-time" deliveries of a critical component. These disruptions cause economic losses up and down the affected chain. If the domestic laws of the nation where the financially troubled, GSC member is located are not drafted to alleviate this distress and restart the stalled production lines expeditiously, substantial economic losses will likely follow. In situations where the economies of various nations dependent on supply chains contemporaneously suffer severe recessions, *e.g.*, the World Financial Crisis of 2008–2012 and the East Asian Financial Crisis of 1997–1998, the absence of "GSC-friendly" laws can exacerbate economic woes in the afflicted region.

Attempts by legislators and other public policy makers to amend their domestic insolvency and related laws are often unsuccessful or become stalled in legislative or bureaucratic processes. Amendments of insolvency or contract-enforcement remedies are typically not high priority items on legislative agendas in many countries, including those of the United States and other developed nations. However, one possible vehicle for affecting these amendments to national laws is suggested: to include provisions in bilateral or regional free trade agreements requiring treaty signatories to enact these amendments on an

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[1] In a soon-to-be published article on GSCs, co-author here, Professor Christoph Paulus, distinguishes between "factual interruptions" of supply chains, *e.g.*, those caused by labor strikes and destructive weather, and "legal interruptions," such as those caused by the insolvency of a chain member. This article concerns the latter type of interruption. In his forthcoming article, Professor Paulus argues that the relevant contracts should not be interpreted in a manner that precludes the economic benefits of GSCs.

expedited basis. Free trade agreements ("FTAs") currently being negotiated regularly include provisions requiring signatories to ratify certain international conventions, especially those recognizing and enforcing intellectual property rights, and to create investor-state dispute settlement ("ISDS") mechanisms to resolve controversies relating to foreign direct investment in a treaty state. The suggestion set forth below possesses the added advantage of not injecting politically-sensitive issues into FTA negotiations and should be viewed by the negotiating states as a neutral proposal containing no hidden agendas.

REGIONAL FREE TRADE AGREEMENTS AND THE TPP AND RCEP NEGOTIATIONS

The Birth and Development of Free Trade Agreements

"Free trade agreements" hark back to at least the Eighteenth Century when Great Britain began to expand its trade relations with the world, which expansion was made possible by England's powerful navy and merchant fleet. This practice influenced the infant United States of America, when in 1776, at the birth of the American revolution, the new nation assigned John Adams to create a model free trade agreement for use by the fledgling confederated states. This model agreement was thereafter employed by the United States in negotiating free trade agreements early in its history.

Although regional FTAs (and customs unions) existed before the Twentieth Century,[2] only in the 1990s did negotiations for the creation of regional free trade agreements involving various nations exponentially increase. This decade was marked by the creation of MERCOSUR, or "Southern Common Market," whose initial signatories were Argentina, Brazil, Paraguay and Uruguay. The "single market" of the European Union formally emerged two years later and the North American Free Trade Agreement ("NAFTA") involving Canada, Mexico and the United States became effective the following year.[3]

The foundation of the World Trade Organization ("WTO") on January 1, 1995, was another watershed event for the proliferation of FTAs. One of the

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[2] An important example of an early regional FTA is the Deutscher Zollverein from 1834, which created a customs union among various neighboring states of the former Holy Roman Empire. For an authoritative history of the Zollverein, *see* W.O. Henderson, The Zollverein (1939). An earlier example of an FTA is the European Free Trade Agreement ("EFTA"), which was entered into in 1960 and now has Iceland, Lichtenstein, Norway and Switzerland as its members.

[3] On the Single European Act, *see* H.J. Glaesner, *The Single European Act: Attempt at an Appraisal*, 10 Fordham Int'l L. Rev. 446 (1987). On NAFTA, *see* Ralph Folsom, NAFTA and Free Trade in the Americas: In a Nutshell (4th ed. 2011).

WTO's "Covered Agreements," binding upon all 160 members, is the General Agreement on Tariffs and Trade ("GATT 1994"). This document specifically permits in its Article XXIV the formation of free trade areas and customs unions by means of FTAs.[4] In addition, the requirement of "consensus" that governs the formation of WTO multilateral treaties binding on all members has become an obstacle to the successful negotiation of these agreements. By objecting to the terms of a proposed treaty, one WTO member can effectively block the adoption of a multilateral agreement. A recent example is the objection by India and a few other WTO members to a proposed Trade Facilitation Agreement streamlining customs procedures crafted during the Doha Round of WTO negotiations. India objected to the approval of this treaty on the ground that an unresolved food subsidy and distribution issue involving that country had not been resolved.[5] Although this dispute has since been settled, the proposed treaty on customs procedures has yet to be formally ratified by the WTO member states.[6]

Because of this institutional roadblock to the adoption of multilateral WTO agreements, a number of WTO members have shifted their focus to negotiating FTAs in order to achieve their trade objectives. One major treatise on WTO law calculated that, as of 2011, "a WTO Member [was], on average, a party to thirteen regional trade agreements."[7] The United States and the European Union are among this activist group of countries advancing their trade agendas. The foregoing treatise on WTO law identifies the reasons for this current preference for RTAs:

> At a regional level, it may be possible to achieve a degree of trade liberalisation which may be out of reach at the global level. It has been

[4] The introduction, or chapeau, of Article XXIV:5 of the GATT 1994 provides as follows: "[T]he provisions of this Agreement shall not prevent . . . the formation of a customs union or of a free-trade area or the adoption of an interim agreement necessary for the formation of a customs union or free-trade area."

[5] *See, e.g.*, Amy Kazmin, *Modi's trade torpedo leaves business confused*, Financial Times, p. 5, col. 3 (August 2–3, 2014); Editorial, *Time to rethink the way WTO takes its decisions*, Financial Times, p. 10, col. 1 (October 14, 2014); Shawn Donnan, *WTO leader calls for urgent debate to remedy paralysis*, Financial Times, p. 2, col. 4 (October 17, 2014).

[6] *See, e.g.*, Amy Kazmin & Shawn Donnan, *US and India end stand-off over food security*, Financial Times, p. 6, col. 6 (November 14, 2014); Shawn Donnan, *WTO breakthroughs fail to mask serious structural problems*, Financial Times, p. 2, col. 5 (November 17, 2014); Shawn Donnan, *Dealmaker in charge at the WTO faces tough fight*, Financial Times, p. 2, col. 1 (December 3, 2014).

[7] Peter Van den Bossche & Werner Zdouc, The Law and Policy of the World Trade Organization, p. 651, (3d ed. 2013).

> argued that trade liberalisation will occur more quickly if it is pursued within regional trading blocs, and that trade liberalisation achieved at a regional level may serve as a stepping stone for trade liberalisation at the multilateral level at a later time. Also, regional trade liberalisation may create significant economic growth within the region concerned, which can, in turn, generate more trade with the rest of the world. . . . Apart from economic reasons, countries may also have political reasons to pursue deeper economic integration and trade liberalisation with some other countries. The example par excellence here is the European Union, which, through economic integration of, and trade liberalisation between and among, its Member States, sought to create, and was successful in creating, an ever closer union' among the peoples of Europe to avoid the recurrence of war.[8]

Finally, relevant to this article's conclusion is the growing trade negotiation practice to include provisions that advance beyond the confines of "pure" trade measures, *e.g.*, those that lower tariffs and insure national treatment of imported goods. Beginning in the 1990s and accelerating during the next two decades, the practice of including in FTAs provisions that have a weaker nexus with the nuts and bolts of international trade in goods has developed and is being pursued in many current trade negotiations. One major (and controversial) example are provisions (i) defining the rights and facilitating the economic opportunities of citizens of FTA signatories investing within the national borders of other signatories, and (ii) establishing international arbitral remedies in the event of certain ISDS disputes relating to these investments.[9] Other similar provisions require signatory nations to ratify specified international copyright, patent and trademark treaties and compel treaty states to insure access to national tribunals for enforcement of internationally recognized labor rights.[10] These FTA provisions substantially modify national laws, *e.g.*, by permitting investor-state disputes to be decided by international arbitration panels rather than by the national courts of a treaty state.

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[8] *Id.* at pp. 651–652.

[9] *See, e.g.*, Shawn Donnan, *Toxic Talks: Critics claim that international arbitration, once used to challenge injustice, has morphed into a weapon that multinationals wield to threaten governments and influence trade negotiations*, Financial Times, p. 11, col. 1 (October 7, 2014); John Kay, *Free trade should not put democracy in the dock*, Financial Times, p. 7, col. 6 (February 4, 2015).

[10] For examples of these provisions, *see* Chapters 17 and 20 of the 2004 United States-Chile Free Trade Agreement, accessible at www.ustr.gov/trade-agreements/free-trade-agreements/chile-fta/final-text.

History, Objectives, and Current Status of TPP and RCEP Negotiations for Pacific-Rim FTAs

The TPP Negotiations

In 2002, the three Pacific-Rim countries of Chile, New Zealand, and Singapore began negotiations for a free trade agreement under the moniker, "Pacific Three Closer Economic Partnership." In 2005, Brunei Darussalam joined these negotiations and, since then, the name of the negotiating group has been changed to "Trans-Pacific Partnership" ("TPP") and eight additional states have joined, including trading heavyweights such as the United States, Japan, Canada, and Mexico. Approximately 40 percent of global economic output will be affected by any resulting treaty. At least 39 "formal" negotiating rounds and meetings of "Ministers" and "Officials" have taken place since the United States joined the talks in January, 2008, with the most recent round of trade discussions having taken place in Hawaii in July, 2015. Earlier in 2015, the United States Trade Representative ("USTR") in an interview expressed his hope that anticipates that these negotiations will be soon completed so as to place the resulting agreement before the U.S. Congress for approval by the end of the year.[11] On June 24, 2015, the United States Congress granted to the President "fast-track" authority for presentation of a negotiated TPP agreement for expedited Congressional consideration and approval.

The TPP negotiators' goals are set forth in detail in the Report of the Trade Ministers of the negotiating states addressed to their national leaders dated November 10, 2014. These goals include such traditional trade topics as the lowering of tariffs, customs facilitation, the guarantee of national treatment for imported goods, and the elimination of nontariff barriers to trade. The negotiations also involve what the trade ministers described as "new trade issues," including foreign direct investment, e-commerce, government procurement, environmental protection, and labor rights.[12]

The direct economic impact of a TPP RTA on all treaty states is expected to be substantial. The USTR's Web site cites a recent analysis reporting that the combined Gross Domestic Product ("GDP") of the treaty states amounted to $28.1 trillion in 2012, which accounts for 39 percent of the world GDP. According to this study, U.S. goods and services exported to other TPP states amounted to $1.8 trillion in 2012, which was 37 percent of U.S. export trade

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[11] Shawn Donnan, *US trade chief moves within reach of big Trans-Pacific prize*, Financial Times, p. 5, col. 1 (February 3, 2015).

[12] The TPP Trade Ministers' Report to Leaders dated November 10, 2014 may be accessed at ustr.gov.about-us/policy-offices/press-office/press-releases/2014/Trans-Pacific-Partnership-Trade-Ministers-Report-to-Leaders.

that year. Growth of U.S. export trade with TPP nations increased by 46 percent between 2009 and 2012. The study predicts that a TPP RTA will generate $305 billion in additional exports per year by 2025, including an additional $123.5 billion of U.S. exports.[13] U.S. trade statistics are also broken down on the Web site by states. For example, in the State of Michigan, which is central to the American auto industry, approximately 70 percent of the state's export goods are presently traded with TPP nations. The top three product categories traded by Michigan with these countries are transportation equipment, machinery manufactures and chemical products.[14]

The creation and development of global supply chains, which are discussed below, constitute one of the United States' primary goals in the TPP negotiations. Supply chains critical to the manufacture of complex products such as motor vehicles fabricate a major part of exported goods throughout the world economy. Many such chains have been created within the last 20 years in East Asian nations. According to the USTR, one of the "defining features" of the TPP negotiations is "to facilitate the development of production and supply chains among TPP members."[15] In addition, these negotiations aim to "support the deep integration of US logistics, manufacturing, and other industries in regional supply chains."[16]

The RCEP Negotiations

The FTA negotiations under the RCEP rubric are an initiative of the Association of Southeast Asian Nations ("ASEAN") involving the 10 members of this association[17] and the six nations that have entered into FTAs with ASEAN:

- the People's Republic of China;
- Japan;
- South Korea;
- India;
- Australia; and

[13] https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2013/December/TPP-Economic-Benefits.

[14] *See* the information and the interactive map of the United States at https://ustr.gov/tpp.

[15] United States Trade Representative Web site, "Outlines of TPP," accessible at ustr.gov/Tpp/outlines-of-TPP.

[16] *Id.*, "Summary of US Objectives," accessible at ustr.gov/tpp/summary-of-US-objectives.

[17] The 10 members of ASEAN are Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.

- New Zealand.

This initiative began in 2012 and the next year, the Trade Negotiating Committee of RCEP issued its Joint Statement following that committee's first meeting. Like the TPP, this group included in its goals for a resulting FTA the development of "global and regional supply chains."[18] The Guiding Principles of the RCEP, adopted by the participating nations, announced that these negotiations should be concluded by the end of 2015. To date, eight rounds of negotiations have taken place, the last such meeting having been held in Kyoto, Japan from June 5–13, 2015.

It has been estimated that the trade area to be covered by this agreement encompasses approximately three billion people, which is approximately 42 percent of the world's population. The share of global trade of the participating countries is approximately 27 percent and their total GDP amounts to a sum in the neighborhood of $21 trillion. If both the TPP and RCEP negotiations produce FTAs, their impact upon world trade and global supply chains should be massive.[19]

GLOBAL SUPPLY CHAINS: WHAT THEY ARE, WHERE THEY ARE, AND HOW FRAGILE THEY CAN BE

Description of Global Supply Chains and Their Development

Supply chains, which consist of a network of businesses that are interlinked and independent in serving one or more customers, have formed a part of the world economy for more than 100 years. Supply chains include:

- vendors that transform raw material into "intermediates" (*e.g.*, components included in composite goods via manufacturing and assembly processes) and final products;
- warehouses that store the intermediates and final products;
- distributors that deliver intermediates to other fabricators and final products to retailers; and
- retailers that sell or lease these goods to end users such as consumers (*e.g.*, automobiles) and businesses (*e.g.*, industrial machinery).

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[18] The Joint Statement of the First Meeting of the RCEP Trade Negotating Committee dated May 10, 2013, may be accessed at http://www.asean.org/images/2013/other_documents/Joint_statement_1st_RCEP%20TNC_08May2013_final.pdf.

[19] *See, e.g.*, the analysis of the RCEP by the New Zealand Ministry of Foreign Affairs and Trade, which may be accessed at http://www.mfat.govt.nz/Trade-and-Economic-Relations/2-Trade-Relationships-and-Agreements/RCEP.

When supply chain members are located in different nations, these chains are denominated as "global supply chains" or "global value chains" ("GVCs"). GSCs have a long history of development in the automotive industry, although they are critical to production and distribution of other goods, such as electronics, farm/plantation products (*e.g.*, fruits, vegetables, meat) and textiles.[20]

"Global" supply chains extend across national borders. A typical example of this cross-border activity is provided by automotive manufacturing and assembly operations in the three NAFTA countries. Ford Motor Company's Hermosillo Stamping & Assembly Plant in the State of Sonora, Mexico, assembles Ford Fusion and Lincoln MKZ automobiles from components fabricated by suppliers located in Mexico and other nations and then ships the finished motor vehicles to the United States and China for delivery to dealers and ultimate sale or lease to business and individual consumers. Many of the intermediate components used in these vehicles are assemblies of parts manufactured by lower-tiered suppliers and then shipped to a "Tier 1" supplier for further assembly and delivery to Ford's Hermosillo plant.

GSCs were born and developed originally in more advanced nations, typically those that were located in North America and Europe. However, as world economic development has spread beyond those continental boundaries during the last three decades, GSCs have multiplied and flourished in developing countries. The 2014 World Trade Report published by the World Trade Organization ("WTO"), describes this phenomenon:

> More than half of developing country exports in value-added terms involve GVCs. The share of trade in parts and components between developing countries has quadrupled over the last 25 years. Services play a central role and constitute more than one-quarter of exports from developing countries. Developing economies are becoming important sources and recipients of foreign direct investment (FDI).[21]

Finally, GSCs are primarily regional creatures. In his 2013 seminal article on

[20] *See, e.g.*, Patrick Mears & Michal Barlowski, *Global Supply Chains in Cross-Border Troubled Supplier Situations: Considerations for Counsel in Advising Affected GSC Members*, Bloomberg BNA International Trade Reporter, (January 28, 2015) (hereinafter "Mears/Barlowski"). *See also* Karina Fernandez-Stark, et al., The Fruit and Vegetables Global Supply Chain: Economic Upgrading and Workforce Development, Duke Center on Globalization, Governance and Competitiveness (Nov. 2011), accessible at http://www.cggc.duke.edu/pdfs/2011-11-10_CGGC_Fruit-and-Vegetables-Global-Value-Chain.pdf.

[21] WTO, World Trade Report 2014 Trade and Development: Recent Trends and the Role of the WTO, p. 79, Geneva, accessible at www.wto.org/english/res_e/publications_e/wtr14_e.htm.

GSCs, Richard Baldwin observed that most of the "large numbers" analyzed in his work "indicate a strong supply chain relationship in the regional blocks, what [Baldwin calls] Factory Asia, Factory North America and Factory Europe."[22] Baldwin's "factory economies" are those "whose exports contain a large share of imported intermediates."[23] A joint study by the WTO and IDE-JETRO published in 2011 used as an illustration of this "regional clustering of tasks" the importation by Japanese motor vehicle assemblers of key components from four members of the ASEAN Free Trade Area:

- Thailand (press parts, electronic parts, engine parts);
- Philippines (engine fuel system, suspension parts);
- Indonesia (cylinder block, engine valves); and
- Malaysia (instrumental assembly, drive shaft).[24]

Baldwin has predicted that production of intermediates will further shift from countries such as China, Mexico, and Poland to countries with lower production costs, *e.g.*, Vietnam, and thereby broaden even more the geographical scope of GSCs.[25]

Fragility of Global Supply Chains and Sources of Their Disruption

Supply Chain Risks: Sole-Source Suppliers and Just-in-Time Inventory Systems

The term, "supply chain risk," has been defined as "the potential occurrence of an incident or failure to seize opportunities with inbound supply in which its outcomes result in a financial loss for the [purchasing] firm."[26] If a supply chain is interrupted for a prolonged period of time, substantial financial losses can be suffered by members up and down the chain. Suppliers may be unable to obtain raw materials and components necessary to fabricate composite parts for delivery up the chain either (i) to a higher-tiered supplier for inclusion in

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[22] Richard Baldwin, Global supply chains: why they emerged, why they matter, and where they are going, in Deborah K. Elms and Patrick Low, eds., "Global value chains in a changing world," p. 20, World Trade Organization, Geneva (2013) (hereinafter "Baldwin").

[23] *Id.*

[24] World Trade Organization and IDE-JETRO, Trade patterns and global value chains in East Asia: From trade in goods to trade in tasks, p. 16, World Trade Organization (2011), accessible at https://www.wto.org/english/res_e/booksp_e/stat_tradepat_globvalchains_e.pdf.

[25] Baldwin, *supra* note 22, at 48. *See also* A tightening grip: The future of Factory Asia, *The Economist*, pp. 61–62 (March 14–20, 2015).

[26] George A. Zsidisin & Bob Ritchie, eds., Supply Chain Risk: A Handbook of Assessment, Management and Performance, pp. 3–4 (2009).

another assembly, or (ii) to the assembler of the final product for distribution and sale to consumers. In these circumstances, production lines will often shut down and anticipated cash flows will be reduced or stop altogether, thereby causing financial losses to most, if not all, chain members. Such disruptions may be severe and sometimes fatal to chain members when they are prolonged and involve "sole source" suppliers (viz., a supplier that has an exclusive production contract with its customer, such that the supplier cannot be readily replaced with another member in the chain) and when a "just-in-time" inventory system is employed in the chain, i.e., when chain members maintain few, if any, stocks of inventory to use; these inventories are obtained periodically on an "anticipated need" basis.[27]

Headline-grabbing supply chain disruptions are often those that result from natural disasters or labor strife. The tsunami-caused shutdown and implosion of nuclear reactors in Fukushima in 2012, resulted in a large dispersion of radioactivity within Japan. This disaster interrupted production lines of a significant number of GSCs in that island nation.[28] The same scenario was played out in Thailand in 2011, when catastrophic flooding shut down supply chains in automotive facilities located there. Combined losses of three Japanese auto companies, Honda, Toyota, and Nissan, caused by these floods were estimated at approximately $6 billion.[29] Labor strikes at port facilities will retard and even halt the inbound and outbound flows of intermediate goods to be used by members of supply chains. These interruptions occurred in 2015, when a labor dispute triggered a union strike and resulting prolonged closures of various ports on the West Coast of the United States. This shutdown of important ports such as those of Los Angeles and Long Beach, California, caused the cancellation of numerous sailings from Asia to the West Coast and has resulted in "supply chain disruption from the after-effects of a simmering labor dispute despite a return to work at west coast ports that had been in 'gridlock.'"[30]

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[27] *See, e.g.*, Patrick E. Mears & James T. Gregg, *Chapter 11 Cases Involving Automotive Suppliers and Their Customers*, in Collier Guide to Chapter 11: Key Topics and Selected Industries ¶ 23.02[4] (Alan N. Resnick and Henry J. Sommer, eds.).

[28] *See, e.g.*, World Bank Institute, Economic Impacts: Cluster 6: The economics of disaster risk, risk management and risk financing, World Bank, Washington, D.C. (2014), accessible at https://wbi.worldbank.org/wbi/Data/wbi/wbicms/files/drupal-acquia/wbi/drm_kn6-3.pdf.

[29] *See, e.g.*, Masahiko Harajuchi and Upmanu Lall, Flood risks and impacts: A case study of Thailand's floods in 2011 and research questions for supply chain decision making, International Journal of Disaster Risk Reduction, New York, (2014), accessible at http://water.columbia.edu/files/2014/10/supply_chain_Thailand.pdf.

[30] Robert Wright, *US supply chains face lengthy turmoil despite ports deal*, Financial Times, p.

Insolvency-related Sources of GSC Disruptions

GSCs that involve "sole source" suppliers and operate with "just-in-time" inventory systems, the prime example of which are automotive industry GSCs, are particularly vulnerable to supply chain disruptions caused by the business failures of critical chain members. There will be no immediate source of supply to replace a financially troubled supplier in a supply chain when the supplier is a party to contracts that identify it as the only source of an intermediate used in the chain. In addition, suppliers using just-in-time systems typically do not maintain large inventory banks to sustain their manufacturing operations in periods of interrupted supply. A serious supply situation often results when a supplier of a critical intermediate product lacks sufficient cash flow to fund its operating expenses. That producer may simply cease business operations or seek relief under national insolvency laws to either liquidate or reorganize its operations, thereby requiring the other chain members to scramble in an effort to maintain production, either by propping up the weak chain member or arranging for its removal from the chain and its substitution by another entity.

Commencement of Contract-enforcement Actions in National Courts by Solvent Supply Chain Members Against the Troubled Supplier

If the troubled supplier is incapable of being reorganized either inside or outside of an insolvency proceeding, the other chain members will normally act to promptly (i) recover any necessary tooling used by the failed supplier to fabricate intermediates; (ii) terminate their contractual relations with the troubled supplier; and (iii) resource the fabrication work to a financially healthy replacement. If these objectives are not quickly achieved, the production of the necessary intermediates may cease altogether, thereby threatening continued production of the ultimate product by the chain. A prolonged shutdown of production lines will likely cause the other members to suffer financial losses arising from breaches of contracts for sale and delivery of the product to customers along with incidental and consequential damages. If applicable national laws do not permit the other chain members to obtain this relief without undue delay or forbid it altogether, then these losses will indeed follow.

In order to afford the solvent supply chain members effective relief against a financially troubled supplier who has no realistic hope of maintaining production, the applicable national laws should be carefully reviewed by domestic policymakers and their lawyers to determine if these laws currently provide outside of insolvency proceedings the following rights and remedies:

4, col. 1 (February 23, 2015). *See also* Robert Wright, *US ports dispute chokes off key trading routes*, Financial Times, p. 12, col. 4 (February 20, 2015).

- the recognition that solvent members of the chain hold rights to recover quickly all tooling in the possession of the troubled supplier, which tooling is necessary for production. These rights would become immediately enforceable when the troubled supplier fails to perform its production and delivery obligations under its supply chain contracts. In many (if not most) cases, obtaining possession of this tooling will be necessary to shift production to a replacement chain member. Fabricating substitute tooling and testing it through required Production Part Approval Processes ("PPAP") can be expensive and time-consuming.
- the ability to compel the troubled supplier to deliver promptly finished inventory to the chain member contractually entitled to its receipt, on the basis that the solvent chain member has a special property interest in that product.
- the entitlement to seek termination of the supply chain contracts with the troubled supplier on an expedited basis to enable the other chain members to resource the work to another supplier.

Commencement of Insolvency Proceedings by the Troubled Supplier

If the troubled supplier seeks to cooperate with other chain members in order to continue production but requires additional financing and protection from its other creditors, the supplier may commence an insolvency proceeding in national courts, either (i) to permit it to sell its business operations on a "going concern" basis to a replacement supplier who would also receive an assignment of the troubled company's supply chain contracts; or (ii) to reorganize its business while obtaining necessary financing during the proceedings to pay its ongoing operating costs throughout the reorganization process. The other chain members will often appear in these proceedings to enforce their rights and claims against the financially troubled debtor and to ensure that normal production of the critical intermediate continues unabated during the pendency of the proceedings. In some cases, these chain members may provide postpetition financing to the debtor to avoid interruption in the supply chain.

In order to protect the interests of the solvent chain members during the course of such insolvency proceedings, the applicable national insolvency laws should contain, at a minimum, the following provisions:

- The national insolvency laws should grant the solvent supply chain members standing to participate in the insolvency proceedings notwithstanding that those members may lack a monetary claim against the debtor. All members are parties in interest to these proceedings because their rights against the debtor may be affected by court orders entered during the insolvency case.

- These laws should also permit solvent chain members holding monetary claims against the debtor to register their claims with the insolvency court and to participate *pari passu* in distributions with other creditors, notwithstanding that these chain members may not be nationals of the forum state. Such a requirement is similar to the provisions in UNCITRAL's Model Law of Cross-Border Insolvency insuring equal treatment of claims of foreign creditors.
- The national insolvency laws should allow for the entry of an injunction against all actions by creditors against property of the debtor during the proceedings, unless the insolvency court orders otherwise after proper notice and a hearing. This relief is necessary to the maintenance of the chain's production processes and their performance during the reorganization proceedings.
- The insolvency laws should permit the post-insolvency financing of the debtor's operations after the proceedings are commenced in return for a priority claim for any losses resulting from the debtor's failure to repay these postpetition loans. This remedy will grant the solvent chain members an opportunity to arrange for continued production by the debtor until the locus of that production is changed to a purchaser of the debtor's assets or until the debtor is successfully reorganized and exits from the insolvency proceeding.
- The national laws should permit the solvent chain members to petition the insolvency court for a prompt termination of their supply chain contracts with the debtor or for a prompt decision by the debtor concerning the debtor's treatment of these contracts in the reorganization case. These laws should also permit the debtor to assume and, if desired, assign the supply chain contracts to a substitute chain member so that production will continue unabated.
- The national laws should provide efficient means for an effective reorganization of the debtor pursuant to a negotiated plan or otherwise.
- These laws should authorize the insolvency court to order the debtor to liquidate its assets and appoint an insolvency administrator to oversee this process in the event that the court determines, after notice and a hearing, that (i) the continuation of reorganization proceedings will serve no purpose because the debtor is unable to reorganize within a reasonable time; and (ii) that the continuation of the proceedings will likely result in further losses to creditors.

The absence of these provisions in national laws permitting uninterrupted production in insolvency situations may negatively affect world trade involving GSCs, thereby creating a drag on the efficiency of this trade and the increase of its costs. If continued production of intermediates by a chain member threated by insolvency cannot be assured, fabrication may come to an expensive halt. If supply chain disruptions result from inadequate legal remedies provided by nations that support large networks of GSCs, the overall cost of international trade involving these nations will almost certainly rise, thereby inhibiting worldwide economic growth and improvement in living standards. Examining the laws of certain of the states currently engaged in the TPP negotiations, a number of national laws contain less-than-optimal protections against supply chain disruptions caused by business failures by one or more members of a chain.

Brief Analysis and Discussion of Contract Enforcement and Insolvency Laws of Potential TPP and RCEP Signatories

At this point in our analysis, it should be worthwhile to discuss the contract enforcement and insolvency laws of a few of the nations engaged in the TPP and the RCEP negotiations in an attempt to obtain some understanding of how these laws might operate in the situation where insolvent and/or illiquid GSC members based in those nations halt production on account of their financial condition. Are the laws of these countries adequate to protect the interests of the non-defaulting chain members by enforcing provisions in the GSC contracts to provide continued production by the defaulting GSC member outside or inside of an insolvency proceeding involving that member as its subject?

In addition to reviewing the national laws themselves, which may only tell a part of the story, we have also examined the World Bank's "Ease of Doing Business" Rankings for 2015 with respect to the countries below. Every year, the World Bank publishes rankings for 189 nations and some economic/trade areas (*e.g.*, Hong Kong) with these entities' composite scores and their scores in each of the ten factors identified by the World Bank as critical to determining the ease of doing business within the borders of these particular entities. For our purposes, two of these categories are important: (i) Enforcing Contracts; and (ii) Resolving Insolvency. The indicators developed by the World Bank in the Enforcing Contracts category are the following:

> (i)The number of procedures to enforce a commercial contract from the commencement of the litigation and continuing through trial and judgment and ending with enforcement of the judgment; (ii) the time necessary to complete each of these procedures measured by calendar days; and (iii) the total cost required to complete these procedures measured by the percentage of the total claim for breach of contract.

These costs include average attorneys fees, court costs and enforcement costs.[31]

The factors in determining the ranking of nations in the "Resolving Insolvency" matrix are more numerous and complex than those involved in "Contract Enforcement." The World Bank uses two categories of indicators under Resolving Insolvency: the "recovery of debt indicators" and the "strength of insolvency framework" indicators. The following indicators are involved in the first subcategory:

- the time required to recover the debt, measured in terms of years;
- the cost required to recover the debt, measured as a percentage of the debtor's estate;
- the outcome of the proceeding, viz., whether the debtor's business continues as a going concern or is liquidated piecemeal; and
- the recovery rate for secured creditors, measured by cents on the dollar.

The "strength of insolvency framework," which measures the quality of the insolvency laws that govern relations among debtors, creditors and the insolvency court, is dependent on the following subcategories:

- the commencement of insolvency proceedings and the availability of liquidation and reorganization proceedings;
- the management of the debtor's assets, which includes the continuation and rejection of executory contracts and the availability of post-commencement credit;
- the reorganization proceeding index, which concerns the approval and content of a reorganization plan; and
- the creditor participation index.[32]

Myanmar

Viewing Myanmar's laws through the prism of the World Bank's "Ease of Doing Business" rankings for 2015, Myanmar's national contract enforcement and insolvency laws are extremely ineffective to protect the interests of non-defaulting GSC members. Myanmar's rank under the category of Resolv-

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[31] For the World Bank Group's detailed description of the methodology used to determine rankings in the category of "Enforcing Contracts," *see* www.doingbusiness.org/methodology/enforcing-contracts.

[32] For the World Bank Group's detailed description of the methodology used to determine rankings in the category of "Resolving Insolvency," *see* www.doingbusiness.org/methodology/resolving-insolvency.

ing Contracts is #185 out of a total of 189 nations and trade areas subject to these rankings. Myanmar earned the slightly higher score of #160 under Resolving Insolvency, which is somewhat surprising in light of the fact that Myanmar lacks an insolvency law for commercial entities, *e.g.*, corporations. However, creditors whose debts have not been paid by defaulting business entities may petition for and sometimes obtain a dissolution of these entities by a Myanmar court.[33]

The law on the enforcement of contracts in Myanmar is based upon the Contract Act of 1872, enacted during the British colonial occupation. According to the OECD, the "[l]egal and procedural requirements for enforcing contracts [in Myanmar] remain complex and uncertain. International observers are unanimous on the need to strengthen the legal certainty and predictability of the regime for property rights protection."[34] Concerns have also been expressed concerning the independence of the Myanmar judiciary in resolving legal disputes.[35]

Brunei Darussalam

Brunei's score on Enforcing Contracts for 2015 is #139; its Resolving Insolvency ranking of #88 is significantly better. Brunei is a former British colony and its contract enforcement and insolvency laws have strong roots in earlier British legislation. Brunei's legislation on enforcement of contracts appears to be particularly helpful to non-defaulting GSC members when confronted with a defaulting member located in Brunei. Brunei's Specific Relief Act permits recovery of movable property in the possession of a third party by persons entitled to its immediate possession. In addition, this Act permits specific performance of a contract where "the act agreed to be done is such that pecuniary compensation for its nonperformance would not afford adequate relief" to the non-breaching party and also where it is probably that adequate compensation cannot be obtained against the party breaching the contract.[36] This Act further provides that a receiver for the breaching party may be ordered by the court in accordance with Brunei's rules of civil procedure.[37] It appears that Brunei's Specific Relief Act could provide a proper framework to decree specific performance of a GSC contract or order its termination.

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[33] *See, e.g.*, section on "Myanmar" in E. Walde Warner, Jr. & Gavin R. Skene, Project Finance in 45 Jurisdictions Worldwide (2011), accessible at www.dfdl.com.

[34] OECD, Investment Policy Reviews: Myanmar, p. 114 (2014).

[35] *Id.*

[36] Specific Relief Act of Brunei Darussalam, Chapter 109, Section 11.

[37] *Id.*, at Section 43.

Brunei legislation also has adopted in its Companies Act the English "Scheme of Arrangement" that would permit a Brunei court to enforce a reorganization plan for a troubled business entity that is approved by the requisite majority of its creditors. Such a plan could provide for an adjustment of the company's "share capital" and also provide for the transfer of the company's assets and liabilities to a successor entity. In these proceedings, the court may appoint a liquidator or an "Official Receiver" to accomplish the directives in the approved scheme. The court may also order the winding up of the company in accordance with the scheme.[38] Consequently, such a scheme could provide for the reorganization of a defaulting GSC member in the context of court proceedings somewhat similar to the Chapter 11 process in the United States.

Vietnam

Vietnam's score in the World Bank's Enforcing Contracts category is relatively high—#47 out of 189 economic zones. Vietnam's score in the Resolving Insolvency matrix is, however, relatively low with a ranking of #104. However, in June, 2014, Vietnam adopted a new insolvency law designed to facilitate business reorganizations and to make these proceedings more accessible and debtor-friendly.[39] This law will took effect on January 1, 2015, and therefore, the World Bank's current ranking in the Resolving Insolvency category is likely irrelevant to the "facts on the ground." The provisions of the new law contain provisions permitting the continuation of business by a business entity that becomes the subject of an insolvency petition and also contains provisions for reorganization plans. With respect to Vietnam's contract enforcement laws, they appear to be relatively straightforward and generally permit the non-breaching party to seek either termination of the contract and damages or to request specific performance by the non-breaching party of the contract's provisions.[40]

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[38] *See* Companies Act of 1957 (amended 2010) of Brunei Darussalam, Sections 151, et. seq.

[39] For the English text of Vietnam's 2014 Insolvency Law, *see* http://www.itpc.gov.vn/investors/how_to_invest/law/Law_on_Bankruptcy_2014_0/mldocument_view/?set_language=en.*See generally* Le Net, Contract Law in Vietnam (2012).

[40] *See generally* Le Net, Contract Law in Vietnam (2012).

A POSSIBLE SOLUTION: HARMONIZATION OF NATIONAL CONTRACT-ENFORCEMENT AND INSOLVENCY LAWS THROUGH FREE TRADE AGREEMENTS

Broadened Rights and Protections in Free Trade Agreements

National Laws with an "Indirect" Impact on International Trade have been Significantly Changed by Selected Provisions in Free Trade Agreements

As previously mentioned, a substantial number of existing bilateral and regional FTAs contain provisions that require treaty states to reform their domestic laws to accomplish objectives that are indirectly related to the trade of goods and services across national borders, *e.g.*, objectives other than adjusting tariff rates, guaranteeing national treatment to imported goods, and facilitating the clearance of goods through customs. For instance, free trade agreements often grant substantial protections for foreign direct investment, including provisions creating dispute settlement mechanisms for aggrieved foreign investors, such as arbitration in lieu of proceedings in the courts of the treaty state in which investments are made. Another example is a provision requiring treaty states to subscribe to certain international treaties protecting intellectual property rights, *e.g.*, the Berne Convention. "Association Agreements" proposed by the European Union ("EU") often require a multitude of changes to national laws of the corresponding treaty states that require extensive changes to a broad spectrum of their national laws. These agreements are employed by the EU to compel political changes in the treaty states, often as a prelude to their possible EU membership.

Suggested Provisions in Free Trade Agreements for Revisions to National Laws Concerning Enforcement of GSC Contracts and Reform of Insolvency Proceedings of Financially Troubled GSC Members

International trade through the medium of GSCs functions as a broad platform for world economic development. As noted above, the important role played by GSCs today is expected to expand in other low-wage nations as labor costs in developing countries increase. However, the risk of supply chain disruptions resulting from the business failures of members of these chains threaten to impose financial losses on these chains in the absence of effective national legislation minimizing the impact of these disruptions. This legislation should enable production to continue unabated in the face of these business failures. The potential costs incurred in negotiating appropriate provisions in bilateral FTAs and RTAs should not be substantial. This subject would constitute just one more matter to be negotiated by the states involved in the discussions and, as described herein, these changes could be surgically made and negotiating them need not be expensive or time-consuming.

Example of the March 2014 Recommendation of European Commission Calling for Changes to National Laws to Provide for Insolvency Rescue Proceedings

One recent example of a similar initiative supported by the Treaty on the Functioning of the European Union is the Recommendation of the European Commission issued on March 14, 2014, to the Member States urging them to enact insolvency legislation facilitating a "rescue culture" for failing businesses. In this Recommendation, the Commission advocated the establishment, by means of new Member State legislation, to "improve returns to creditors and the flow of cross-border investment" and to impact positively "in terms of entrepreneurship, employment and innovation." This anticipated legislation should include certain principles permitting, inter alia, (i) authorizing out-of-court restructurings; (ii) providing for a temporary injunction against creditor enforcement actions; and (iii) facilitating the adoption of rehabilitation plans to reorganize financially troubled companies. After 18 months elapse from the issuance of this Recommendation, the Commission will review the status of Member State compliance and decide whether "further measures [are required] to strengthen the horizontal approach on insolvency are needed." Although not specifically identified in the Recommendation, these further measures could include a directive or a regulation to enforce this compliance.[41]

Suggestions for Free Trade Agreement Provisions to Minimize Insolvency-related, GSC Disruption Risks

Limited Scope of National Law Amendments and Eligibility for Relief Thereunder

Any proposed amendments to existing insolvency laws of a treaty state could be contained in a separate section of applicable national laws and drafted to limit the eligibility for relief thereunder to financially troubled members of a "supply chain." The term, "supply chain," could then be defined to capture all such entities and render them eligible for relief under this special section of the treaty states' national laws. In this fashion, extensive changes to a significant

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[41] *See generally,* Patrick E. Mears, *The Winds of Change Intensify Over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 Pratt's J. Bankr. L. 349 (June 2014). The European Insolvency Regulation (the "EIR"), which regulates insolvency proceedings involving members of the European Union (other than Denmark, which opted out of this regulation), has expanded its reach to include "pre-insolvency" or preventative proceedings in addition to traditional insolvency actions. The bulk of the revised EIR becomes effective on June 26, 2017.

number of national laws could be avoided.

Suggested Amendments of National Law for Prompt Recovery of Tooling and Finished Inventory in the Possession of the Troubled Supplier

The national laws could be amended to create expedited court procedures to enable other, solvent members of supply chains to recover possession of tooling necessary to continue production of the intermediates and all finished inventory in the possession of the troubled supplier. This remedy would be similar to replevin actions typically available in common law countries to recover property from a third person in which the complainant holds a legally protected interest and superior right to possession. National laws could also be amended to grant to the solvent members legal standing to commence and pursue these claims in non-insolvency courts.

Suggested Amendments of National Law for Special Reorganization and Liquidation Provisions of GSC Members

This article has generally described the changes that should be incorporated into national insolvency laws and procedures in insolvency proceedings of "supply chain members." These suggestions include provisions permitting the prompt termination of supply chain contracts to which the debtor is a party or their assumption by the debtor or its insolvency administrator and, if appropriate, their assignment to a third party who would become responsible for continuing production. Other suggestions address, *inter alia*, proceedings for the allowance of claims held by foreign supply chain members in insolvency proceedings and the prompt reorganization or orderly liquidation of the insolvent supply chain member.[42]

CONCLUSION

It is recommended that policy makers of developed and developing nations involved in negotiating free trade agreements propose provisions for inclusion in these agreements similar to the suggestions above. The benefits resulting from their inclusion should be positive and uncontroversial. In periods of financial crisis, the resulting amendments to national laws should benefit the economies of affected states dependent upon global supply chains and immunize not only the healthy chain members from economic losses but also protect employees and other entities dependent on the continued existence and functioning of these chains. These suggested changes to national laws need not

[42] The various suggested changes to national laws to protect against insolvency-related disruptions to supply chains are also discussed in Mears/Barlowski, *supra* note 20.

be scripted in detail. Legislation embodying the critical features described herein would be left to the negotiating treaty states to fashion so as to conform to their own legal and cultural milieus.

Finally, although this article analyzes GSCs in the context of the TPP and RCEP negotiations, the suggestions contained herein are not limited to those potential free trade areas. Sought-after changes to national laws relevant to the uninterrupted and efficient functioning of GSCs effected through the medium of free trade agreements could also be negotiated in other agreements.