Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Private Equity Wants To Buy Your Asbestos Liabilities

By **Stephen Hoke** (October 31, 2019, 3:43 PM EDT)


Stephen Hoke

Nothing commands more interest from our asbestos and other mass tort clients than potential extrajudicial approaches that provide certainty and finality for addressing their long-tail legacy liabilities. There are several alternative risk transfer opportunities that can provide relief from the distraction and risk that saps corporate focus and financial resources.

Typically, there are three ways for a legacy liability defendant to secure finality and certainty: (1) prepackaged or prearranged bankruptcy; (2) purchasing insurance or reinsurance for their book of losses; and (3) selling the liability to a third-party. This article addresses the merits and disadvantages of these approaches, focusing especially on the sale of legacy liabilities to third-party buyers.

A third-party sale is generally less expensive than the other options, and provides a large measure of the desired finality and certainty. As if on cue, BorgWarner Inc., a major asbestos defendant, just announced the largest such legacy liability sale to date on Oct. 30.

524(g) Prepackaged or Prearranged Bankruptcy

The only sure way to escape being an asbestos or other mass tort defendant with finality is through the bankruptcy process. Most recent large asbestos bankruptcies involve a 524(g) prepackaged (or prearranged) bankruptcy.

In prepackaged bankruptcies, the corporation files a Chapter 11 petition after having negotiated a proposed settlement with plaintiffs attorney creditors in advance of filing, seeking to confirm a Chapter 11 plan under Section 524(g) of the Bankruptcy Code for asbestos liabilities or Section 105(a) for nonasbestos legacy liabilities. The proposed terms would include a channeling injunction, which protects the defendant from being sued by asbestos claimants in any future claims.

While this provides certainty and finality for the corporate defendant, the consideration it must provide to secure agreement from plaintiffs counsel is painfully expensive. Bankruptcy transaction expenses are also high, and the process can drag on for months or years.

The entire process is messy, and the ultimate outcome uncertain, as other creditors and insurance company debtors can and do aggressively object to their treatment in the proposed plan. As a result, 524(g) or 105(a) bankruptcies are typically suitable for only the most financially threatened companies.

Purchase Insurance for the Entire Loss Portfolio

There has long been a market in which insurers transfer liability or purchase reinsurance for their entire long-tail loss portfolios. Insurers such as American International Group, The Hartford Financial Services Group Inc., CNA Surety Corp. and Liberty Mutual Insurance Group themselves opted for finality by transferring or reinsuring their asbestos and other legacy liabilities, with Berkshire Hathaway Inc., Enstar Group Ltd. and Catalina Holdings Ltd. being the most active reinsurers in the market. Insurance is also available to noninsurer corporate defendants for their asbestos and other mass tort claims losses with various insurers and reinsurers, including Berkshire.

There have not been many loss portfolio insurance transactions in the last decade. The principal impediment is price. The transactions that have been consummated typically involve a relatively small claim book, a less price-sensitive defendant, and a particular desire to mitigate the risk in advance of a significant anticipated financial transaction.

There have been far fewer instances of defendants insuring or reinsuring losses above their legacy coverage. Typically, this insurance is only economical for losses above expected as measured in an actuarial analysis. Most companies that put their legacy risk out for bid, but opted not to proceed, did not have the circumstances or financial wherewithal to meet the price demanded by the insurance market. And the lack of a broad and robust competition for such deals among insurers allows the market to demand a premium price.

Another disadvantage to purchasing loss portfolio insurance is that it does not provide finality. An insurer can go insolvent, or the limits of a policy can be exhausted. ACE learned this the hard way when the $3 billion in reinsurance it purchased for its historical asbestos liability book of claims exhausted, returning the financial and operational responsibility to it.

Also, although insurance can provide financial and operational comfort — if not near long-term certainty — the liability remains on the balance sheet as a contingency that must be valued on an annual basis. Thus, even if an asbestos defendant is willing to pay the substantial premium for reinsurance of its entire claim book, it still will not have achieved the finality management so craves.

Third-Party Sale of Liability

The remaining risk transfer alternative involves isolating and selling the legacy liability to a third party, who manages, runs off and pays the claims in return for a substantial payment to the buyer as consideration. The third-party buyer can be someone with whom the seller has an existing relationship, or an entity that specializes in such purchases. Third-party buyers may be private equity firms or domestic or foreign insurance entities.

There is a third-party commercial market for these transactions, and several such deals have been consummated. In return for assuming the liability, the buyer receives a substantial cash premium, and transfer or assignment of any existing insurance proceeds. Typically, the loss portfolio is isolated, and converted or sold into a litigation shell owned and operated by the third-party buyer. To date, the third-party transactions that have been completed appear to have functioned as intended, and corporate defendants generally have successfully achieved their objectives.

Third-party buyers such as Global Risk Capital LLC have been active in the market for over a decade, and have an established record of success. Enstar Group, an insurer, has ventured into the sector, closing on two large third-party purchases of asbestos risk, from Dana Inc. in 2016 and from BorgWarner just this week.

The third-party buyer approach provides the seller with financial and operational finality, save for the worst-case hypothetical scenario where the buyer fails to meet its obligations to plaintiff creditors at some time in the future and is forced to file for bankruptcy. In this case, the legal risk likely would return to the corporate seller, and it would once again be exposed financially and operationally.

Off-Balance-Sheet Nature

In addition to providing finality, a sale of legacy risk to a third-party buyer removes the liability from the seller’s balance sheet. This is generally considered an advantage to the purchase of loss portfolio insurance from an insurer. Even if the risk may be comfortably insured for the long-term, it remains on the balance sheet, and will need to be annually valued and booked.

Also, even if the risk is fully sold, it bears noting that, if the buyer is a public company or an insurer, the risk will be publicly reported as part of the buyer’s disclosure obligations. Thus, while it is off the balance sheet for the seller, it will still optically be associated with the liability through ordinary investigation.

Operational Changes

A third-party sale should eliminate the operational burdens of defending the claims. Responsibility for interacting with insurers, if any, transfers to the buyer. If there are disputes with the insurers post-transaction, they are the responsibility of the buyer.

Responding to discovery in the underlying cases transfers to the buyer, although the seller will need to provide the necessary documents and information to the buyer in the transaction to ensure the smooth transition of the defense. It is also common for the seller to be asked post-transaction to provide institutional knowledge when questions arise, although these requests should diminish over time.

It should be noted that claimants' counsel ordinarily does not object to a sale to a third party, as long as settlements are paid in full and there is no perception that the buyer is taking unjustified discovery positions.

Cost

The substantial cost of the upfront payment, and the question of trusting a third party to properly run off legacy liabilities, are the primary impediments to successfully completing a third-party sale.

The principal driver of price is the valuation of the loss portfolio liability, offset by the value of any existing historical insurance and/or other assets. The buyer prices the transaction using the same types of metrics employed by any private equity business buyer, including the anticipated cash flows from investment of the returns of the upfront cash payment, new revenue streams and improved operational efficiencies.

New revenue streams might include the anticipated identification of new insurance assets, more effective insurance recovery strategies and the monetization of existing insurance through policy commutations. Potential operational efficiency improvements can include reduced defense expenses and indemnity payouts through the implementation of more effective litigation strategies or economies of scale.

New revenue streams and expense reduction typically do little to diminish a seller's sticker shock upon first receiving a price quote. Nothing changes the fact that asbestos has a long and potentially expensive tail. However, prices should diminish, as mesothelioma claims filings appear to have peaked, and there is better data for buyers (and sellers) to confidently value the liabilities.

Additionally, a private equity firm may be able to offer a better price than an insurer operating in a regulated environment. Of course, the regulatory burden and discipline of the insurance industry does provide a measure of security that a noninsurer cannot provide.

Trust and Security

Given the possibility that a third party buyer may go bankrupt or dissolve, there is the fundamental question of whether the seller can trust that the buyer will diligently and competently run off the risk without misusing or absconding with the funds paid to assume the liability. Sellers will find that they typically cannot negotiate for financial security in the transaction.

A bond would simply be too expensive, and personal guarantees by the buyer principals likely would be a deal-killer. Likewise, a letter of credit would eliminate the buyer's principal revenue stream of investing income. Payment terms might provide a measure of security, but could implicate disclosure obligations decreasing the desired finality. Trust is best established by means of due diligence of a third party buyer's experience and track record.

Sale to a Related and Trusted Third-Party Buyer

An alternative to a marketplace third-party buyer is to isolate the liability into a separate corporate form, and select managers and professionals that the company is familiar with and trusts. This is a low-profile option, highly dependent on circumstances, ownership and managerial preference, and frequently has been quietly successful.

In practice, the legal structures implemented to pursue this strategy vary widely in the degree to which the litigation shell is designed to operate independently. The more independent the structure, the less likely that claims such as fraudulent conveyance, alter ego and piercing the corporate veil might succeed should the entity fail.

A company considering this option must consider the risk and reward of ceding to the buyer full independence in running off the risk, as opposed to maintaining it as a subsidiary. Oftentimes, a company might try to have it both ways, leaving the company partially, but not fully, independent. This raises issues such as degrees of common ownership, common management, consolidation of financials and access to corporate credit that must be carefully considered.

Most important, the valuation of assets and liabilities exchanged in the restructuring of the company to implement such a strategy is especially critical. Any assets separated from the liabilities must be professionally and credibly valued, as they will be challenged if the litigation shell fails. The liabilities and accompanying insurance assets must also be professionally valued, to defend against any claims of insolvency or inadequacy of consideration should the entity fail.

Conclusion

The third-party sale of asbestos and other legacy liabilities to private equity is a viable corporate strategy that can deliver finality and certainty. It can be less expensive than, and has disclosure advantages over, prepackaged bankruptcy and loss portfolio insurance. Nonetheless, it can be expensive and raises trust and security issues. Still, there are experienced third-party buyers with a record of success, and more entering the space, as evidenced by the recent BorgWarner transaction.

Stephen Hoke is a partner at Hoke LLC.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.
