Tackling Long-Tail Legacy Liability Risk: A Defendant's Toolkit

By **Stephen Hoke**
Published May 11, 2023, *Law360: Expert Analysis*


Stephen Hoke

Three and a half years ago, I addressed the subject of transferring legacy liabilities in asbestos and other mass tort cases in a Law360 guest article.

Since its publication, interest in options to limit or achieve finality with respect to long-tail and legacy liabilities has grown.

The national media has closely followed the latest such strategy, the "Texas Two-Step," which has proven successful for a handful of large companies seeking to isolate and spin off large asbestos and talc liabilities.

However, Johnson & Johnson was recently rebuffed in its efforts to employ the strategy, calling into question its future viability. And on April 26, as a result of several recent large jury verdicts related to legacy talc liabilities, Berkshire Hathaway Inc. filed Chapter 11 bankruptcy on behalf of Whittaker Clark & Daniels Inc., which it purchased in a 2006 private equity transaction.

This is the first prominent mass tort private equity deal to fail. While the future consequences are unclear, it is likely to affect what has become an increasingly popular means to address long-tail legacy liabilities.

This article addresses these legal options, as well as others potentially available to asbestos, talc and other mass tort defendants.

Introduction

The long-expected decline in asbestos claims is ongoing. Instead of reducing liabilities, it has been met by plaintiffs counsel taking more cases to trial and obtaining higher "social inflation" jury verdicts.

These drive downstream settlements even higher. At the same time, as asbestos and talc bankruptcies proceed apace, plaintiffs continue to seek out and sue more tertiary middle market and small company defendants. The net result is increasing volatility in the asbestos space.

More and more of these exhausted defendants are in search of finality. The motives are not just the ongoing costs but also a desire to limit disclosure obligations, prepare the company for a future sale and to reduce uncertainty so that the company can focus on its core business.

There are various alternative risk transfer opportunities, corporate reorganization options, and other legal techniques available to defendants. In the last few years, new approaches have emerged as possible options and refinements on previous strategies.

The toolbox now includes the following: (1) corporate reorganization; (2) Chapters 7 and 11 bankruptcy; (3) Chapter 11, Section 524(g) of the U.S. Code, prepackaged or prearranged bankruptcy; (4) Texas Two-Step bankruptcy; (5) dissolution; (6) loss portfolio transactions; and (7) liability sale to private equity. This article addresses these approaches discussing the positives and negatives of each.

Evaluating the Situation

Most companies with long-tail legacy liabilities eventually become discouraged. Management puts pressure on legal, finance and/or risk management to do something.

While this is to be expected, the never-ending nature of asbestos is particularly difficult to navigate and endure. There are always improvements to be made in the defense of the claims and insurance recovery, but the legal options to secure finality are usually premature when the company first "kicks the tires."

It is often difficult for a company to grasp that asbestos is just different. It may seem as if the sky is falling if you have 500 asbestos claims, but it simply puts you in the middle of the pack — not necessarily in need of a dramatic immediate solution.

Most companies that are first investigating their long-term options can benefit from a professional analysis of their claim situation. It is rare that a company first reaches out when bankruptcy is a real consideration.

When the company is not insolvent, corporate reorganization to isolate the liabilities is frequently worthy of consideration as is a potential loss portfolio transfer or a sale to private equity. Most often, though, companies in the early stages of exploring their options reasonably elect to postpone any such decisions until the situation worsens.

Chapter 7 Bankruptcy

If the company has limited assets and no desire to exit bankruptcy as an ongoing concern, Chapter 7 can be an attractive option.

It requires the retention of bankruptcy counsel to prepare and file a petition. Immediately thereafter, the U.S. Bankruptcy Court appoints a trustee to maximize the remaining assets and run off the liabilities. Because the company will no longer exist when the bankruptcy is complete, it is the ultimate form of finality.

One issue that should be considered is that the trustee has a fiduciary duty to the creditors and the estate. Management will have no control over the liquidation.

If the trustee determines that the directors, officers and other interested parties mismanaged company assets to their advantage prior to bankruptcy, he or she can pursue them individually. This should be considered when determining whether the company should file a Chapter 7 or a Chapter 11 bankruptcy or whether a different approach should be pursued.

Chapter 11 Bankruptcy

Even if the company files for bankruptcy with no intention of emerging as an ongoing concern, a Chapter 11 bankruptcy can still be an option.

Typically, a Chapter 11 bankruptcy is used to reorganize the company with a plan to emerge as an ongoing business. However, when there are sufficient available assets, a Chapter 11 bankruptcy can be used to wind down the liabilities even if there is no intention to remain in business.

Depending on the circumstances, for various reasons management may prefer to maintain control subject to the supervision of the bankruptcy court and without the involvement of a trustee.

The recently filed Whittaker Clark Chapter 11 bankruptcy is a good example.

If successful, a regular Chapter 11 bankruptcy with no intention to exit as a reorganized business provides certainty and finality.

Chapter 11, Section 524(g) Prepackaged Bankruptcy

Chapter 11 is not a viable candidate for asbestos defendants that seek to remain an ongoing business because it would be subject to post-bankruptcy claims.

Chapter 11, Section 524(g) allows for asbestos defendants to reorganize and exit bankruptcy with a "channeling injunction" barring any future asbestos claims.

The critical feature of a 524(g) is that it requires that the bankrupt fund a trust that can fairly compensate future claimants indefinitely into the future. Once a plan is confirmed, the reorganized company emerges from bankruptcy with protection from future asbestos claims.

While this provides the requisite finality, the process is difficult and time-consuming, and the funding of the trust is expensive.

By its nature, a 524(g) triangulates plaintiffs, the company and its insurers in a three-way battle. Typically, plaintiffs and the company reach a prearranged agreement as to funding of the trust dependent, in part, on maximizing available insurance proceeds. Naturally, in response, the insurers aggressively seek to limit their exposure.

The entire process is contentious, expensive and highly unpredictable.

As such, it is most frequently used by larger companies with serious liabilities, a desire to remain an ongoing concern and the ability to shoulder the time and expense required to do so.

The Texas Two-Step

The Texas Two-Step is a particular form of a 524(g) bankruptcy that has garnered substantial attention of late.

The "first step" involves the company incorporating in Texas, which permits the company to split itself into separate entities, separating the assets and liabilities via a divisive merger.

Section 1.002(55)(A) of the Texas Business Organizations Code allows for the isolation of operational assets from the legacy liabilities. And Section 1.008(a)(4) of the Texas Business Organizations Code states that the ongoing corporate entity created in the merger is not liable for the debt or other obligation of the legacy liability holding entity.

The "second step" is for the new liability entity to file for a 524(g) in the U.S. Bankruptcy Court for the Western District of North Carolina, which is in the Fourth Circuit.

The Fourth Circuit applies a more pliable good faith test for bankruptcy filings than other circuits. The advantage of this approach is that it allows the company to seek finality without subjecting the core business to bankruptcy. Also, it enables the company to qualify for bankruptcy on the liability entity alone even if the company would not otherwise be insolvent.

Several large companies with substantial legacy liabilities have successfully completed the Texas Two-Step including Georgia-Pacific LLC, Ingersoll Rand Inc. and CertainTeed. Recently, Johnson & Johnson attempted to utilize the Texas Two-Step to address its talc/asbestos litigation by filing for bankruptcy for its newly created liability entity, LTL Management LLC.

However, the bankruptcy court transferred venue to New Jersey, which is in the Third Circuit. The bankruptcy petition was dismissed in January by the Third Circuit, holding that the debtor did not suffer from financial distress and the filing did not serve a valid bankruptcy purpose under Title 11 of the U.S. Code, Section 1112(b).

The court reasoned that because Johnson & Johnson had $61.5 billion in prebankruptcy assets, it had more than enough assets to satisfy the projected liability. The court noted, "[g]ood intentions, such as to protect the J&J brand or comprehensively resolve litigation, do not suffice alone."

While Johnson & Johnson refiled its bankruptcy petition in April, committing more funds and representing that a majority of plaintiff creditors support the revised plan, the conflict between the circuits and the future viability of the Texas Two-Step likely can only be resolved by the U.S. Supreme Court.

In the meantime, its questionable legal future — in combination with the cost required to pursue the strategy — renders it available in a practical sense to only the most sophisticated companies.

However, to the extent that the Texas Two-Step strategy survives, the approach will become normalized and thus available to a greater array of companies.

Dissolution

When properly executed, dissolution provides finality. Most states have laws that provide for a company to dissolve.

Of course, it is only used when the company has no intention of remaining an ongoing business. A company seeking to dissolve must take care to ensure that the technicalities of the applicable state's law are followed.

The dissolved entity must provide notice to all creditors and typically must also publish general notice to potential creditors as required by the company's state of incorporation. This is usually at a minimum publication in a local newspaper at least once or more. Most state statutes bar claims asserted two to five years after dissolution.

Companies seeking to dissolve may reincorporate in a state with shorter waiting periods and publication requirements. Michigan, for example, has a one-year waiting period and publication need only be made in the county of the company's registered agent.

Meeting the precise requirement of the governing statute is critical as courts closely scrutinize the process. Any failure to follow a technicality can undo the effects of the dissolution should present or future creditors object.

Creditor claims asserted predissolution and during the wind-up period need to be resolved in order to complete the process. A creditor that meets the statutory deadline but still has an unresolved claim when the statutory period ends can usually pursue the dissolved entity until resolution within the regular court system.

The dissolution process is complete when all assets are properly disposed of and all eligible liabilities resolved.

Dissolution can be especially effective for addressing long-tail claims.

It tends to work best when there are a limited number of such outstanding claims. Depending on circumstances, publication can drive new claims during the dissolution period. While this alone does not disqualify the desirability of dissolution, it can complicate the process, especially if there is outstanding insurance available to pay claims.

Of late, it has become commonplace in states such as Delaware, South Carolina and Massachusetts for dissolved companies to be revived — typically on petition by asbestos plaintiffs firms — in order to access unused historical insurance assets.

The states that permit revival typically require the creditor to petition the court to have a receiver appointed to run-off the risk.

Because insurance is the only remaining asset, only the insurance companies are at risk until their limits are exhausted.

Loss Portfolio Transfer

A company may opt to purchase insurance for its long-tail loss portfolios.

Insurance companies including CNA Financial Corp., the London Market Group and American International Group Inc. have purchased reinsurance from other insurers such as Berkshire Hathaway Inc., Enstar Group Ltd. and Global Risk Capital LLC for long-tail liabilities.

Noninsurer corporate defendants may also seek to transfer their liability book to insurers. These transactions are more common for small claim books or if there is a need to posture the company for sale to a company that is skittish of asbestos risk. Such transfers are also used to insure losses above existing legacy coverage.

A disadvantage of loss portfolio insurance is that it does not provide finality as an insurer can become insolvent. Another disadvantage is the available limits can be exhausted when the reinsurance exceeds its stop loss.

Last, while by its very nature loss portfolio insurance provides substantial protection for legacy liabilities — including permitting the defendant to focus on its core business — the risk remains an on-balance sheet contingency that must be valued and disclosed.

Private Equity Sale

An increasingly popular vehicle for disposing of legacy liabilities is selling the liability to a private equity buyer.

The seller separates its operating assets from the liabilities and corresponding historical insurance assets so as to not run afoul of no assignment clauses in the policies.

The liability book is then sold to the private equity market for cash representing the fair market value of the assets less the FMV of the historical insurance.

It is becoming increasingly common for corporate defendants to reorganize in anticipation that it may need to dispose of the risk sometime in the future. This is frequently accomplished by the corporate defendant creating a NewCo parent that pays the OldCo parent for the FMV of the operating assets.

This isolates the liability and insurance into a separate vehicle that is run-off as a litigation shell and preready for sale at some time in the future. It is critical that the healthy assets are purchased by NewCo at FMV with competitive terms in order to limit the risk of any claim of fraudulent conveyance should the OldCo become insolvent.

The benefits of a private equity sale are many. The buyer assumes full responsibility for owning, managing, responding to discovery and paying the claims as well as insurance recovery.

While the seller must assist in the transfer of the institutional knowledge necessary to defend the claims, in practice after the hand-off the company has little to no role in defending the claims. Post-transaction, asbestos is generally now off-balance sheet.

It also makes the company more attractive to potential buyers. Plaintiffs counsel generally have no interest in challenging a private equity sale as long as their claims continue to be paid.

The disadvantages of a private equity legacy liability sale are cost and trust. The cash price the seller pays the buyer is based on an FMV actuarial assumption of the projected liabilities less the FMV of insurance. The private equity buyer assumes that its experience in defending asbestos claims can reduce both the cost of defense and indemnity mitigating the price it will demand. Nonetheless, the sticker shock discourages most sellers leaving all but the largest defendants capable and willing to close a transaction.

However, prices have become more competitive as accumulating claims data makes risk easier to underwrite. The process typically involves an auction in which there may be five to 10 initial bidders.

As the sector continues to mature the underlying claims data continues to become more precise. This makes for more willing bidders and more competitive pricing.

Care should be taken as there are always new inexperienced players attempting to enter the market by buying market share.

The biggest conceptual hurdle to private equity sales is the moral hazard of cutting a substantial check to a third party with minimum conditions. As buyers silo the risk, there is the possibility that the purchase vehicle can go bankrupt due to unexpected acceleration in asbestos payouts, underpricing and even fraud.

Alternatives available to defendants to allay the moral hazard such as bonding the risk are too expensive and personal guarantees are nonstarters. Letters of credit deprive the buyers' principal source of investment revenue critical to competitively pricing the risk.

Extended payment terms can provide a degree of additional security. Also, a seller can demand that the private equity buyer share the risk by putting some of their own funds at risk.

There is always a risk that unexpected losses may force the buyer to file bankruptcy. Until last month, this had never happened. However, on April 26, Whittaker Clark & Daniels — a litigation shell that was purchased by Berkshire Hathaway in 2006 — filed for Chapter 11 bankruptcy asserting that its talc and asbestos liabilities rendered it insolvent.

Whittaker Clark estimates that it has $1 billion in liabilities and only $500 million in assets. After suffering nearly $48 million in jury verdicts in the last year, Whittaker Clark asserts that Chapter 11 is the only feasible way to obtain finality.

As there have been at least 50 private equity asbestos transactions and this is the first to fail, its long-term consequences are unclear. If the seller is still in business, there is the possibility that plaintiffs may attempt to pursue it based on alter ego or corporate successor liability theories.

However, such claims typically are difficult to prove, especially if the relevant statutes of limitation such as fraudulent conveyance have expired.

Conclusion

Companies have multiple options to reduce or eliminate significant long-tail legacy liability risk. A Chapter 7 or 11 bankruptcy is an option for companies that do not intend to remain in business.

Chapter 11, Section 524(g), which results in the establishment of a trust to pay future claimants, provides finality via a channeling injunction that allows the company to function post-exit without exposure to new asbestos claims. However, the process is contentious, time-consuming and unaffordable for most companies.

The Texas Two-Step is a variation of a 524(g) in which the company incorporates in Texas and undergoes a divisive merger separating its healthy assets from its liabilities. Immediately post-merger, the company files for 524(g) bankruptcy in a federal circuit that previously has approved such plans.

This relatively new approach has been used by large companies with deep pockets. However, its future legal viability is unclear.

Dissolution is also available, but it is usually only employed by companies with little or no operating business and a limited number of outstanding claims. Sales to private equity are becoming more commonplace, although the long-term effects of the recent Whittaker Clark bankruptcy filing is unclear.

Most companies that begin to consider these options initially delay or decline the decision to proceed: most frequently due to cost and/or their liabilities being such that immediate action is unnecessary.

Nonetheless, many of these companies elect to take the preliminary step of a corporate reorganization that isolates the liabilities from the healthy assets in order to posture it for a future transaction.

Stephen Hoke is a partner at Hoke LLC.