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Out-of-Court Restructuring to Exit Asbestos Litigation: Alternative to Chapter 11

This article summarizes the key challenges associated with solving the asbestos litigation problem through the Chapter 11 restructuring process, and explains why an out-of-court restructuring transaction may be a preferred alternative.

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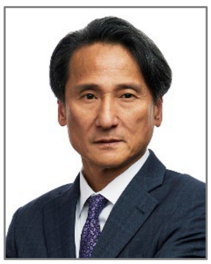

Asbestos litigation continues to rage on in the tort system with no likelihood of receding in the immediate future. In addition to the inherent costs associated with having to defend and settle asbestos claims, managing asbestos litigation can be a significant distraction for corporate officers and directors from running their businesses. The overhang of asbestos litigation can also severely dampen the value of an otherwise successful and profitable company.

For these and other related reasons, companies have continued to look for ways to exit the tort system. Historically, companies facing legacy asbestos liabilities had limited options—either continue to litigate and settle the lawsuits in the tort system, or find a permanent solution through the bankruptcy process. Judge Burton Lifland's decision in *In re Johns-Manville* paved the way for companies and their affiliates to exit the tort system by establishing a trust, and then channeling all present and future asbestos claims to that trust. *Manville*, 68 B.R. 618, 624 (Bankr. S.D.N.Y. 1986), aff'd, 78 B.R. 407 (S.D.N.Y. 1987), aff'd sub nom. *Kane v. Johns-Manville*, 843 F.2d 636 (2d Cir. 1988). Judge Lifland's bankruptcy solution for dealing with asbestos litigation was well received by lawmakers, and was later codified under §524(g) of Chapter 11, title 11, of the United States Code.

While §524(g) provides a much needed solution for companies facing legacy asbestos liabilities, it does not come without its challenges. First and foremost, Chapter 11 bankruptcies come with a significant transactional cost, as the debtor must bear the costs of its own restructuring professionals as well as those of other primary players in the bankruptcy. Second, the bankruptcy solution requires the funding of an asbestos trust, where the amount of funding is a byproduct of negotiations with the plaintiffs' representatives. And most importantly, when and how the debtor will emerge from Chapter 11 is rarely a matter of certainty as the debtor simply cannot confirm a plan of reorganization without the requisite vote of the asbestos claimants.

Many of these challenges, however, may be avoided through an out-of-court restructuring transaction. While such a transaction will not offer the broad protections of a federal court channeling injunction, a properly structured transaction can provide similar benefits for companies seeking to exit the litigation.

This article summarizes the key challenges associated with solving the asbestos litigation problem through the Chapter 11 restructuring process, and explains why an out-of-court restructuring transaction may be a preferred alternative.

Challenges of Chapter 11 Process

Transactional Costs. Asbestos bankruptcy cases are extremely expensive. Typically, the debtor will have to retain bankruptcy counsel and a financial advisor. It will also have to retain an economic consultant to help calculate an estimate of present and future asbestos liabilities. To the extent the debtor has any remaining liability insurance, the debtor will require the services of insurance counsel not only to calculate the amount of remaining coverage and the solvency of each insurer, but also to interface with insurance companies who tend to be active in asbestos bankruptcy cases. In addition to these costs, most asbestos bankruptcies will involve a future demand holders' representative to represent the interests of future asbestos claimants. Such a representative will often retain his or her own bankruptcy counsel, financial advisor and economic consultant. In addition to an official committee of unsecured creditors, which will have its own attorneys and financial advisors, the U.S. Trustee likely will form an official committee of asbestos claimants. The official asbestos claimants committee will retain its own bankruptcy counsel, financial advisor and economic consultant.

All of these professionals' fees and costs must be borne by the debtor's estate. As a point of reference, the fees and expenses in the *Manville* case were estimated at approximately $100 million in 1988 dollars; *W.R. Grace* totaled $283.6 million in 2007; In 2009, the *ASARCO* professionals were awarded about $120 million; professionals received about $42.6 million in the relatively small *Eagle-Picher* reorganization; even prepackaged bankruptcies can cost a fortune. For example, *Halliburton* spent approximately $27.6 million in fees and expenses in 2004. See Kevin H. Hudson, Comment, *Catch 23(b)(1)(B): The Dilemma of Using the Mandatory Class Action To Resolve the Problem of the Mass Tort Case*, 40 Emory L.J. 665, 694 n.115; *Baker Botts v. ASARCO*, 576 U.S. 121 (2015); S. Elizabeth Gibson, *Case Studies of Mass Tort Limited Fund Class Action Settlements & Bankruptcy Reorganizations* 185 (2000) at 98, 240; ARTICLE: PREPACKAGED ASBESTOS BANKRUPTCIES: DOWN BUT NOT OUT, 63 N.Y.U. Ann. Surv. Am. L. 727 at 749.

Costs of Funding the Trust. Once an asbestos defendant files for Chapter 11 protection, all pending and future asbestos litigation comes to a screeching halt pursuant to §362 of the Bankruptcy Code. And if the debtor successfully confirms a plan of reorganization with a §524(g) channeling injunction, all such pending and future asbestos claims will be paid through the trust established under §524(g)(1)(B) of the Bankruptcy Code.

The asbestos trust essentially replaces both the debtor and the tort system to compensate the asbestos claimants. Accordingly, the single most significant question in an asbestos bankruptcy case is the amount of funding that should be provided to the trust. While the answer to this question is largely driven by the estimates of economic consultants and negotiations among the debtor, the future demand holders' representative and the official asbestos claimants committee, the fact that at least 75% of asbestos claimants must vote in favor of the plan in order for the debtor to emerge from bankruptcy complicates the negotiations.

The size of the funding for an asbestos trust varies from case to case, and can well exceed $1 billion. Some examples are *W.R. Grace & Co.*, at $2.98 billion, *Armstrong World Industries*, at $2.06 billion, *Babcock & Wilcox Company*, at $1.85 billion, *Celotex Corporation/Carey Canada*, at $1.25 billion, *Combustion Engineering*, at $1.24 billion, *Johns-Manville/Philadelphia Asbestos*, at $2.5 billion, and *Kaiser Gypsum*, at $1.22 billion. See *In re W.R. Grace Co.*, Case No. 01-01139 (JKF); *In re Armstrong World Industries*, Case No. 00-04471 (RJN); *In re the Babcock and Wilcox Co.*, Case No. 00-10992 through 00-10995 (JAB); *In re Celotex*, Case Nos. 90-10016-8B1, 90-10017-8B1 (TEB); *In re Combustion Engineering*, Case No 03-10495 (KG); *In re Johns-Manville*, Case No. 82-11656 (CGM); *In re Kaiser Gypsum Company*, Case No. 16-31602 (JCW).

Uncertainty of a Successful Restructuring. A significant challenge to an asbestos bankruptcy is the uncertainty associated with confirming a plan of reorganization with an asbestos channeling injunction. As stated, the focal point of negotiations for a reorganization plan is the amount of money to be contributed to the asbestos trust. Because §524(g)(2)(B)(ii)(IV)(bb) provides that 75% or more of the asbestos claimants class must vote to accept the plan, the asbestos claimants retain significant leverage in negotiations regarding the funding of the trust.

Until the debtor obtains the support of 75% of the asbestos claimants class, it simply cannot emerge from Chapter 11 with a §524(g) channeling injunction. Thus, unless a debtor is able to negotiate a prepackaged Chapter 11 plan with the plaintiffs' representatives in advance of filing for Chapter 11, the debtor is likely to face significant uncertainties as to how much funding the asbestos trust will require and when it would be able to emerge from bankruptcy.

Out-of-Court Restructuring Alternative

A Chapter 11 restructuring offers undeniable benefits to companies with legacy asbestos liabilities, such as the immediate cessation of all asbestos claims against the debtor and a permanent channeling injunction that is backed by a federal court order. One or more of the above challenges, however, have caused more and more companies to look for an alternative solution.

A properly structured out-of-court restructuring transaction offers a viable alternative for companies wishing to exit the tort system. In broad strokes, the entity with the legacy liabilities is isolated from the operating business, but retains sufficient resources to continue to defend and settle claims. While the details of what such a transaction would look like is beyond the scope of this article, a properly structured transaction will help a company avoid most, if not all, of the above challenges. The transaction costs would be dramatically lower by orders of magnitude, the estimate of present and future asbestos settlement and defense costs are based on expert analyses as opposed to negotiations, and the company dictates the timing. Most importantly, the operating business will realize its actual corporate value without the overhang of asbestos litigation. An out-of-court restructuring provides a real and viable alternative to a Chapter 11 reorganization.

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