International Insolvency Institute

International Insolvency in the New Millennium

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Issues and Solutions for Mass Claims and
Contingent Liabilities in Multinational Reorganizations

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I. Contingent Liabilities and Financial Reporting

A. Nearly every enterprise at any time has contingent liabilities.

B. These are typically one of two principal kinds:

1. From assertion of claims for liability in litigation.

2. From contracts, such as guaranties where the principal debtor has not defaulted.

C. At one stage in the post-World War-II period, there was considerable uncertainty about how enterprises should address contingent liabilities in their financial statements.

1. Some never recorded them as a number under the heading ?liabilities? until they actually had to be paid. This was criticized for ?hiding reality? until the last minute.

2. Others created reserves and other book entries early and were criticized for using management of these entries as an earnings-management tool.

D. Around 1975, under prodding from the SEC, the legal profession (*see* ABA Statement of Policy Regarding Lawyers? Responses to Auditors? Requests for Information (December 1975)) and the accounting profession (*see* American Institute of Certified Public Accountants Professional Standards, Auditing Standards Section 337C) took steps resulting in the adoption of what is now Statement No. 5 of the Financial Accounting Standards Board which defines precisely (or, perhaps better, defines as precisely as possible with respect to a very complex topic) the size and time when reserves for contingent liabilities should appear on the corporate balance sheet. The annual need of auditors to determine if the booking of reserves is adequate under FASB 5 generates the torrent of letters which lawyers are used to receiving to advise accounting firms about contingent liabilities of their clients. The official summary of FASB No. 5 reads as follows:

?SUMMARY

This Statement [No. 5] establishes standards of financial accounting and reporting for loss contingencies. It requires accrual by a charge to income (and disclosure) for an estimated loss from a loss contingency if two conditions are met: (a) information available prior to issuance of the financial statements indicates that it *is probable that . . . a liability had been incurred* at the date of the financial statements, and (b) the amount of loss *can be reasonably estimated.* Accruals for general or unspecified business risks ("reserves for general contingencies") are no longer permitted. . . . Copyright by Financial Accounting Standards Board. All Rights Reserved.? (emphasis added)

II. Example of Application of FASB 5

A. In compliance with FASB No. 5, some companies with large litigation problems (e.g., asbestos) have recorded large- looking liabilities, as shown by the following extract from the December 31, 1999 balance sheet of Owens Corning. Seven months after these financial statements were filed with the SEC, Owens Corning filed for Chapter 11. The main FASB No. 5 asbestos reserve liability lines are emphasized:

?OWENS CORNING AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
DECEMBER 31, 1999 AND 1998

LIABILITIES AND STOCKHOLDERS' EQUITY
(In millions of dollars)

CURRENT	1999	1998
Accounts payable and accrued liabilities	$ 839	$ 942
Reserve for asbestos litigation claims current portion (Note 22)	***950***	***850***
Asbestos related liabilities Fibreboard current portion (Note 23)	900	
Short term debt (Note 3)	68	69
Long term debt current portion (Note 2)	159	22
Total current	2,916	1,883
LONG TERM DEBT (Note 2)	1,764	1,535
Reserve for asbestos litigation claims (Note 22)	***820***	***1,780***
Asbestos related liabilities Fibreboard (Note 23)	938	79
Other employee benefits liability Note 9)	318	326
Pension plan liability (Note 10)	42	55
Other	339	364
Total other	2,457	2,604"

[additional financial data excluded]

B. In explanation of its reserves Owens Corning included a very lengthy footnote describing its asbestos problems and also an ?NSP?, a national settlement program then being used. The footnote reads (in small part) as follows (some deletions of text have not been noted):

?22. Contingent Liabilities

ASBESTOS LIABILITIES

ITEM A. OWENS CORNING (EXCLUDING FIBREBOARD)

[Lengthy text omitted]

Reserve

Owens Corning's financial statements include a reserve for the estimated cost associated with Owens Corning's asbestos personal injury claims. This reserve was established initially through a charge to income in 1991, with an additional $1.1 billion charge to income (before taking into account probable non products insurance recoveries) recorded in 1996. Reflecting the substantial new information about now settled present and expected future claims gained in the NSP negotiations with plaintiffs' law firms, and the recent changes in the legal environment referred to above, Owens Corning in the fourth quarter of 1998 increased its asbestos reserves by $1.4 billion. This resulted in an after tax charge to 1998 earnings of $906 million. Subject to the variables and uncertainties referred to below, Owens Corning estimates that its liabilities associated with pending and unasserted future asbestos personal injury claims and its insurance recoveries in respect of such claims, at December 31, 1999, are as follows:

December 31, 1999	December 31, 1998

(In millions of dollars)		
Reserve for asbestos litigation claims		
Current	$ 950	$ 850
Other	820	1,780
Total Reserve	$ 1,770	$ 2,630
Insurance for asbestos litigation claims		
Current	$ 25	$ 150
Other	205	260
Total Insurance	$ 230	$ 410
Net Owens Corning Asbestos Liability	$ 1,540	$2,220
	=======	=======

[text omitted]

Owens Corning will continue to review the adequacy of its estimates of liabilities and insurance on a periodic basis and make such adjustments as may be appropriate. . . . ?.

C. At the conclusion of its notes to financial statements regarding asbestos liabilities, Owens Corning gives a management opinion about the adequacy of its reserves. Interestingly, Owens Corning has a subsidiary, Fibreboard, with its own asbestos problems. There are reserve calculations and a lengthy footnote about Fibreboard, as well as a management opinion. Here are the two management opinions. Compare the two last sentences (especially the italicized language):

Owens Corning	**Fibreboard**
Management Opinion Although any opinion is necessarily judgmental and must be based on an assessment of the variables and uncertainties described above, in the opinion of management, while any additional uninsured and unreserved costs which may arise out of pending personal injury asbestos claims and additional similar asbestos claims filed in the future may be substantial over time, management believes that such additional costs *will not impair the ability of Owens Corning to meet its obligations or to reinvest in its businesses.*	Management Opinion Owens Corning cautions that its estimate of Fibreboard's asbestos related liabilities is influenced by the same types of variables and is subject to similar uncertainty as in the case of Owens Corning. Although any opinion is necessarily judgmental and must be based on an assessment of the variables and uncertainties described above, Owens Corning believes the amounts available from the Fibreboard Settlement Trust *will be adequate to fund Fibreboard's ongoing defense and indemnity costs associated with asbestos related personal injury claims for the foreseeable future.*

III. When Mass Claims and Contingent Liabilities Threaten Corporate Solvency

A. In recent years, mass tort claims have surfaced in certain categories in the United States to a sufficiently large degree that management has sought protection in chapter 11 filings. Leading examples are:

1. Asbestos - over 25 filings since 1982, including a rash in recent months (e.g., Babcock & Wilcox, Armstrong, Owens Corning, W.R. Grace, GAF)

2. The Dalkon Shield intrauterine birth-control device (A.H. Robins)

3. Silicon breast implants (Dow Corning)

B. Other categories of mass tort claims are occasionally entertained as possibilities for use of chapter 11, but no cases have yet been filed

C. Special problems not related to mass torts also sometimes generate need for, or threat of, chapter 11

1. Texaco suffered a $12 billion trial court judgment in Texas. Under then-applicable state law, Texaco could not obtain a stay of execution on the judgment entered by the trial court without posting a bond (or bank letters of credit) equal to the amount of the judgment. Texaco found that the entire capacity of the worldwide bonding/letter-of-credit industry could not support a bond in the necessary size. In lieu thereof it obtained a novel stay from the U.S. Court of Appeals for the Second Circuit which was later reversed by the United States Supreme Court on grounds of unwarranted federal interference with state litigation proceedings. *See Pennzoil Co. v. Texaco Inc*., 481 U.S. 1 (1987). After this injunction was so vacated, Texaco, fearful of Pennzoil execution proceedings and adversely affected by customer and supplier uncertainty about its prospects, filed chapter 11. Thereafter, the Texas intermediate appellate court affirmed the verdict, *see Texaco, Inc. v. Pennzoil, Co*., 729 S. W. 2d 768 (Tex. App. 1987)(subsequent history omitted). The Texas Supreme Court denied review. While an application for review was pending with the U.S. Supreme Court, a consensual chapter plan was approved. *See In re Texaco, Inc*., 84 B.R. 893 (Bankr.S.D.N.Y. 1988).

2. In unpublicized situations other enterprises in Texaco?s position, i.e., with a large unsatisfied judgment, have had to threaten bankruptcy in order to get relief from the judgment stay in operation.

3. A contingent-liability situation *not involving torts* which produced a major U.S. filing was for Columbia Gas Company and certain subsidiaries. Subsidiaries were parties to literally thousands of obligations, embodied in written contracts, to purchase natural gas at prices significantly above market levels. The company could have simply repudiated the contracts and faced damage suits in various localities around the U.S. Considering this to be too risky and disorderly, the company elected instead to file for chapter 11 and use the contract-rejection provisions of the Bankruptcy Code to eliminate its continuing duty to honor the contracts and to establish its damage liability. After a complex, four-year case, the debtors successfully emerged with a consensual chapter 11 plan.

4. However, mere pendency of litigation is not enough, taken alone, to justify resort to chapter 11. *See In re SGL Carbon Corp. (Official Committee of Unsecured Creditors v. Nucor Corp.)*, No. 99 5319 (3d. Cir. Dec. 29, 1999)(chapter 11 petition filed by otherwise healthy company merely as a means to assist in the defense of antitrust litigation not filed in good faith and must be dismissed).

IV. What Triggers Chapter 11 Filings Due to Mass Claims and Contingent Liabilities?

A. Two types of factors will account for the decision when to file with an enterprise facing mass torts or a contingent liability problem.

1. One is when an event controls the decision. Examples of this would include Texaco, where a decision of the U.S. Supreme Court removed a stay that had given confidence to Texaco?s customers and suppliers. Another example of an event is when the holder of the once-contingent, now real claim actually shows up, with writs, to seize assets.

2. A second is ?mushier?, i.e., when the whole prospect of managing the enterprise in the face of a completely unpredictable incidence of demands for cash to satisfy litigation claims when they turn into amounts actually payable is unacceptable.

V. Solutions to Mass Claims and Contingent Liabilities

A. In the asbestos setting, some variant of the following paradigm is now used in virtually asbestos cases to resolve the liabilities, i.e., the so-called ?golden goose? structure. The ?golden goose? is the industrial company, which provides jobs, pays taxes and generates cash. This it cannot continue with dependability in the face of too much uncertainty about when it will have to use cash to pay the liabilities. The solution? Separate the industrial company from the liability. Under Section 524(g) of the U.S. Bankruptcy Code, the solution is now to have the industrial debtor?s asbestos liabilities discharged (*de jure* or, using injunctions, *de facto*), with such liabilities being assumed by another entity, often a trust (pass-through entity for tax purposes). The former debtor issues stock and pays money to the trust, all conventional and predictable from a corporate finance point of view. The trust deals with the unpredictability of the size, timing and amount of the payments due the contingent-liability claimants.

B. In cases like *Texaco* (single, large litigation claim) and *Columbia Gas* (thousands of breach-of-contract claims) the solution has been simple: cash. Chapter 11 has been used, essentially, as a way to centralize the process and get all parties affected litigating and negotiating in one place.

VI. Multi-National Dimensions of Contingent-Liability and Mass-Claim Cases

A. The foregoing presentation reviews selected issues in the context of:

1. Mass-tort cases, with a focus on asbestos

2. Contingent-liability cases, with a focus on *Texaco* and *Columbia Gas.*

B. In this writer?s experience, neither situation has yet presented itself in the U.S. or elsewhere in a major case with a major multi-national *claims* dimension.

C. Clearly, some of the major debtor?s were multinational. Indeed, Texaco was highly multinational. What is being said is that the situation where the mass claims or contingent liabilities included large numbers of non-U.S. claimants has not yet occurred. So far, virtually all of the asbestos claims and the lion?s share of the Dalkon Shield claims and the breast-implant claims have been U.S. domestic.

D. Hence, the ?multi-national solution? in these cases has been to avoid any adverse effects on the U.S. debtors? cash flows and asset control from adverse effects of being in chapter 11 in the U.S. on non-U.S. operations and assets.

E. The *Owens Corning* case, presently pending, has created some interesting issues of these types. One class of Owens Corning creditors (a bank group) alleges that its debt is guaranteed by a number of Owens Corning subsidiaries, some of which are offshore. None of these subsidiaries has been filed, either under chapter 11 or a non-U.S. insolvency regime. This leaves these entities theoretically open to pursuit by bank creditors of attempts to collect on their guarantees. At the inception of the cases (October 2000), the debtors obtained temporary restraining orders preventing assertion of claims against these guarantor entities. These restraints have been continued through the present (late May 2001) by consent while negotiations about the topic have been continued.