ADMINISTRATION OF LARGE BUSINESS BANKRUPTCY REORGANIZATIONS: HAS COMPETITION FOR BIG CASES CORRUPTED THE BANKRUPTCY SYSTEM?

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

JULY 21, 2004

Serial No. 114

Printed for the use of the Committee on the Judiciary

Available via the World Wide Web: http://www.house.gov/judiciary

U.S. GOVERNMENT PRINTING OFFICE

94–939 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON THE JUDICIARY

F. JAMES SENSENBRENNER, Jr., Wisconsin, *Chairman*

HENRY J. HYDE, Illinois
HOWARD COBLE, North Carolina
LAMAR SMITH, Texas
ELTON GALLEGLY, California
BOB GOODLATTE, Virginia
STEVE CHABOT, Ohio
WILLIAM L. JENKINS, Tennessee
CHRIS CANNON, Utah
SPENCER BACHUS, Alabama
JOHN N. HOSTETTLER, Indiana
MARK GREEN, Wisconsin
RIC KELLER, Florida
MELISSA A. HART, Pennsylvania
JEFF FLAKE, Arizona
MIKE PENCE, Indiana
J. RANDY FORBES, Virginia
STEVE KING, Iowa
JOHN R. CARTER, Texas
TOM FEENEY, Florida
MARSHA BLACKBURN, Tennessee

JOHN CONYERS, Jr., Michigan
HOWARD L. BERMAN, California
RICK BOUCHER, Virginia
JERROLD NADLER, New York
ROBERT C. SCOTT, Virginia
MELVIN L. WATT, North Carolina
ZOE LOFGREN, California
SHEILA JACKSON LEE, Texas
MAXINE WATERS, California
MARTIN T. MEEHAN, Massachusetts
WILLIAM D. DELAHUNT, Massachusetts
ROBERT WEXLER, Florida
TAMMY BALDWIN, Wisconsin
ANTHONY D. WEINER, New York
ADAM B. SCHIFF, California
LINDA T. SÁNCHEZ, California

Philip G. Kiko, *Chief of Staff-General Counsel*
Perry H. Apelbaum, *Minority Chief Counsel*

Subcommittee on Commercial and Administrative Law

CHRIS CANNON, Utah *Chairman*

HOWARD COBLE, North Carolina
JEFF FLAKE, Arizona
JOHN R. CARTER, Texas
MARSHA BLACKBURN, Tennessee
STEVE CHABOT, Ohio
TOM FEENEY, Florida

MELVIN L. WATT, North Carolina
JERROLD NADLER, New York
TAMMY BALDWIN, Wisconsin
WILLIAM D. DELAHUNT, Massachusetts
ANTHONY D. WEINER, New York

Raymond V. Smietanka, *Chief Counsel*
Susan A. Jensen, *Counsel*
Diane K. Taylor, *Counsel*
James Daley, *Full Committee Counsel*
Stephanie Moore, *Minority Counsel*

C O N T E N T S

JULY 21, 2004

OPENING STATEMENT

WITNESSES

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

ADMINISTRATION OF LARGE BUSINESS BANKRUPTCY REORGANIZATIONS: HAS COMPETITION FOR BIG CASES CORRUPTED THE BANKRUPTCY SYSTEM?

WEDNESDAY, JULY 21, 2004

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3:07 p.m., in Room 2141, Rayburn House Office Building, Hon. Chris Cannon (Chair of the Subcommittee) presiding.

Mr. CANNON. The Subcommittee will please come to order.

Increasingly, bankruptcy courts have become the courts of last resort for businesses that need to address extensive claims filed against them. From a societal perspective, Chapter 11 of the Bankruptcy Code reflects the premise that the debtor is economically "worth more alive than dead." The perceived benefit of this process is that, theoretically, it preserves the going concern value of the business, enables the debtor to repay its creditors in part, and provides continued employment for its workers.

From the creditor's perspective, Chapter 11 is a testing ground for the debtor's viability. The debtor can be made to account for its past and present activities, as well as its future business plans. Interested parties may investigate the debtor's financial health and the desirability of continuing the debtor's business.

The progress of a Chapter 11 case is also monitored by the judiciary and the Justice Department. Although bankruptcy judges were removed from the day-to-day administration of bankruptcy cases in 1978 in response to concerns about cronyism in the bankruptcy system, they still serve as the tribunals who must resolve most issues and controversies that arise in bankruptcy cases, including those that are important to the integrity of the system such as those dealing with conflicts of interest.

In addition, the United States Trustee Program, a component of the Justice Department, has administrative oversight responsibility for maintaining the integrity of the bankruptcy system. The program serves as the "integrity watchdog" and is charged with the responsibility to ensure that bankruptcy estates are administered promptly and efficiently. To that end, the program must review applications to retain and compensate professionals in Chapter 11 cases and file objections when appropriate grounds exist. In addition, the program must monitor the debtor's progress toward confirmation.

A series of recent trends and developments, however, have called into question whether the integrity of the bankruptcy Chapter 11 cases is being compromised. These concerns have not gone unnoticed by the media. The Wall Street Journal, for example, published not one but two editorials last month criticizing the bankruptcy system with respect to how it treats asbestos claims.

Today's hearing will focus on some of these issues. For example, it is my hope that the witnesses will address the question of whether the current law and system adequately address the unique issues presented by mass torts and future claims. I believe Professor Brickman, in particular, is prepared to discuss that issue. In addition, my colleagues and I are interested to hear about whether the current law with respect to where Chapter 11 cases may be filed is being manipulated to the detriment of other interested parties and other ramifications of forum shopping. Professor LoPucki, I understand, is prepared to address that issue. We are also fortunate to have a representative from the Department of Justice who will explain the United States Trustee Program's efforts to proactively protect the integrity of the bankruptcy system particularly with respect to conflicts of interest by professionals retained in Chapter 11 cases, compensation requests, and other instances of overreaching by participants in these cases.

I now turn to my colleague Mr. Watt, the distinguished Ranking Member of the Subcommittee and ask him if he has any opening remarks.

Mr. WATT. Thank you, Mr. Chairman. I appreciate the Chairman convening the hearing. It's refreshing, I guess, to have a hearing that you don't really know what the outcome is likely to be. And that is the way the process really ought to work. We should be educating ourselves about these issues on an ongoing basis. And it looks like we've got an outstanding panel of people who are capable of educating us.

So, no sense in me talking any longer. We can get directly to it. And I look forward to hearing the testimony.

Mr. CANNON. Thank you. Without objection, the gentleman's entire statement will be placed in the record. All Members may place their statements in the record at this point. Without objection, so ordered.

Without objection, the Chair will be authorized to declare recesses of the Subcommittee today at any point. Hearing none, so ordered.

I might point out we expect votes at about 4 p.m.. And so we are trying to move through so that we don't delay our witnesses while we vote.

I ask unanimous consent that Members have 5 legislative days to submit written statements for inclusion in today's hearing record. Without objection, so ordered.

I am now pleased to introduce the witnesses for today's hearing. Our first witness, Ms. DeAngelis, appears on behalf of the Executive Office of the United States Trustees, a component of the Department of Justice, that provides policy and management direction to the United States Trustees Program. The program operates through a system of 21 regions. Since March of last year Ms. DeAngelis has served as the acting trustee for Region 3 which comprises the judicial districts of Delaware, New Jersey, and Pennsylvania.

Prior to her present assignment, Ms. DeAngelis served as the Assistant United States Trustee for the District of Delaware from May 2001 to January 2003. Before entering public service, she was a partner in the law firm of Fox Rothschild where she specialized in bankruptcy law. Ms. DeAngelis obtained her undergraduate degree from Alvernia College, and law degree from Seton Hall School of Law.

Our next witness is Professor Lynn LoPucki. Professor LoPucki is the Security Pacific Bank Professor of Law at the UCLA Law School. Before entering academia in 1980, Professor LoPucki practiced bankruptcy law for 8 years. Since then he has taught at Harvard, Cornell, Washington University, and the University of Pennsylvania Law Schools. Over the course of his academic career, Professor LoPucki has authored two books and numerous articles on debtor-creditor relations. His most recent book, "Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts," is scheduled to be published next year. Not soon enough.

Professor LoPucki received both his undergraduate and law degrees from the University of Michigan. He obtained his LL.M. from Harvard.

Our final witness is Professor Lester Brickman. Since 1976 Professor Brickman has been associated with the Yeshiva University's Benjamin N. Cardozo School of Law where he currently teaches contractual law and legal ethics. Over the course of his academic career he has taught at the University of Toledo Law School, Fordham Law School, and Oxford Universities.

Professor Brickman has both published and lectured extensively. He has participated in various activities intended to promote professional responsibility standards in the legal profession, including his work as a Member of the Committee on Professional and Judicial Ethics of the Association of the Bar of the City of New York and the New York State Bar Association's Committee on Professional Ethics. Professor Brickman obtained his undergraduate degree from Carnegie Tech, his law degree from the University of Florida, and his LL.M. from Yale University.

I extend to each of you my warm regards and appreciation for your willingness to participate at today's hearing. In light of the fact that your written statements will be included in the hearing record, I request that you limit your oral remarks to about 5 minutes. Accordingly, please feel free to summarize or highlight the salient points of your testimony. You'll note we have a lighting system in front of you. After 4 minutes it turns yellow. After the fifth it turns red. You don't need to stop, but just be aware that the time is over and to finish your thoughts up. We would appreciate that. I don't like cutting people off, but I'll tap the gavel. It's our custom to tap the gavel at 5 minutes so we don't go on forever with our questions from Members, although when only the Ranking Member and I are here, we're pretty collegial about that as well.

I would now ask the witnesses to please stand and raise your hand right hand to take the oath. Are you all aware we need to do the oath?

[Witnesses sworn.]

Mr. CANNON. Let the record reflect each of the witnesses answered in the affirmative.

Ms. DeAngelis, would you now proceed with your testimony. Let me say Mr. Watt often laughs at how fast I read, but we need to get through these sort of technicalities quickly. And, by the way, we help the recorder by giving her a copy of what I have done. But we would appreciate now—as Mr. Watt said, we are both exploring here and the whole Committee is exploring this issue. It's an issue we care enormously about and look forward to hearing all of your testimony. Ms. DeAngelis.

TESTIMONY OF ROBERTA A. DeANGELIS, ACTING UNITED STATES TRUSTEE, REGION 3, ON BEHALF OF EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES, WASHINGTON, DC

Ms. DEANGELIS. Thank you, Mr. Chairman, Mr. Watt. I appreciate the opportunity to appear before you on behalf of the Department of Justice to discuss the role of the United States Trustee in reviewing applications to employ and compensate professionals in large Chapter 11 cases. Chapter 11 debtors are authorized to employ attorneys, accountants, and other necessary professionals to assist them in their reorganization efforts.

Similarly, official committees of creditors and equity security holders which are appointed under section 1102 of the Bankruptcy Code are authorized to employ professionals to assist in carrying out their responsibilities.

Congress has imposed special rules governing the employment and compensation of bankruptcy professionals. Most importantly, professionals may not be employed or paid without approval of the bankruptcy court. Court approval is sought by filing an application which is noticed to the United States Trustee and other parties in the case.

In my written testimony I describe in greater detail the activities of the United States Trustee regarding the retention and compensation of professionals. The number of actions we have taken in the amount of fee reductions, fee expense reductions, obtained alone cannot adequately convey the significance of the actions that we take. Just as with other regulatory or enforcement agencies, our selection of the right case and obtaining the right result may have deterrent and other salutary effects that promote the integrity of the process, including the expanded disclosure of conflicts and greater restraints on fees.

In my written testimony I provide several examples of recent cases in which the United States Trustee litigated important matters of retention and compensation of professionals. Let me briefly describe two of them. In Re Pillow Tex, the Court of Appeals for the Third Circuit sustained the United States Trustee's position and held that the bankruptcy court could not approve an employment application until it had resolved allegations that proposed counsel for the debtor had received a preferential transfer and therefore was not disinterested.

The law firm settled the matter after remand for a six-figure disgorgement. In In Re Flemming Companies, the United States Trustee for Region 3 objected to the fee applications of debtor's counsel. In a published opinion, the bankruptcy court found that the two firms had rendered services which unnecessarily generated litigation and did not benefit the estate. The court also found that the hourly rates of one of the firm's practitioners were higher than the hourly rates charged by similarly experienced attorneys in other practice areas within the same firm.

In the area of fee review, the courts, the United States Trustee, and others have explored new approaches including some of the following: Courts have appointed fee examiners and fee review committees who submit periodic reports with recommendations for compensation awards. The United States Trustee sometimes uses an internal automated fee review program that permits computerized analysis of fee applications to identify, among other things, possible duplication of effort such as multiple attorneys appearing at meetings and interoffice conferences and the cost of particular tasks such as the aggregate time that is expended to develop a plan of reorganization, for example.

Some courts require professionals to submit budgets reflecting anticipated fees and expenses so that the court, the debtor, and the parties have a better ability to evaluate the likely future course of the case and the costs of professionals.

In summary, Congress has prescribed a comprehensive regimen of legal standards and procedures governing the retention and compensation of professionals employed in Chapter 11 cases. Bankruptcy courts are expressly required to review and approve the employment of all professionals and the payment of all fees and expenses. The responsibility to identify noncompliance with these standards and procedures in Chapter 11 is a responsibility that is shared among the court, the United States Trustee, and other participants in the bankruptcy system.

I appreciate the opportunity to discuss some of the challenges that this responsibility presents as well as some of the emerging issues and possible approaches for future action. And I would be happy to answer any questions from the Subcommittee. Thank you.

Mr. CANNON. Thank you Ms. DeAngelis.

[The prepared statement of Ms. DeAngelis follows:]

PREPARED STATEMENT OF ROBERTA A. DEANGELIS

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before you on behalf of the Department of Justice to discuss the role of the United States Trustee in reviewing applications to employ and compensate professionals in large chapter 11 bankruptcy cases. As the Acting United States Trustee for Region 3, I have responsibility for some of the largest cases filed in the country, including those filed in the district of Delaware.

Title 11 of the United States Code, known as the Bankruptcy Code, provides a comprehensive scheme for the employment of bankruptcy professionals who are paid from bankruptcy estate funds. Under 28 U.S.C. § 586 and other provisions of law, the United States Trustee has authority to review, comment upon, or object to applications to retain and compensate bankruptcy professionals.

Chapter 11 debtors are authorized to employ attorneys, accountants, and other necessary professionals to assist them in the reorganization process. Similarly, official committees of creditors or equity security holders, which are appointed under 11 U.S.C. § 1102, are authorized to employ professionals to assist the committees in carrying out their responsibilities. In light of the multiplicity of interests present in bankruptcy cases and the frequent lack of natural tension that exists in the typical two-party civil proceeding, Congress has imposed special rules governing the employment of bankruptcy professionals. Most importantly, professionals may not be employed without approval of the bankruptcy court. Court approval is sought by filing an application which is noticed to the United States Trustee and, frequently, to other parties in the case. The terms of engagement must be disclosed, including any contingency fee arrangements.

The applicant must demonstrate that it is eligible for employment. The Bankruptcy Code and Rules impose a burden of full disclosure. The professional is required to submit to the court an application that states the following: the specific facts showing the need for the services to be rendered, the name of the person to be employed, the reasons for the selection, the particulars of the services to be rendered, and the terms of compensation. In addition, a verified statement is required from the professional that sets forth all connections the professional has or had with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the office of the United States Trustee. Full and complete compliance requires that the professional report all connections, not just those connections that, in the judgment of the professional, may be relevant. It is the court's task to determine whether the connections are disqualifying. In its administration of chapter 11 cases, the United States Trustee endeavors to assure that the self-reporting required of professionals is provided and that disqualifying connections are brought to the attention of the court.

The basic requirements for the employment of a debtor's professionals are contained in 11 U.S.C. §§ 327, 328, and 101(14). Among other things, professionals "may not hold or represent an interest adverse to the estate [and must be] disinterested." In section 101(14), the term "disinterested person" is defined and sets forth five disqualifying conditions. Some of these conditions are general, but others are more specific. For example, directors and officers who served in those capacities within two years of the filing are per se excluded from employment. The basic requirements for committee professionals are contained in 11 U.S.C. § 1103. These requirements are similar, but not identical to, those governing the debtor's professionals. The notice requirements are contained in Federal Rule of Bankruptcy Procedure 2014 and local rules.

Professionals employed by the debtor or official committees may be paid fees and reimbursed for expenses out of estate funds. Congress has established a scheme for the application, review, and approval of fees in 11 U.S.C. §§ 330 and 331. Other basic requirements are set forth in the Federal Rule of Bankruptcy Procedure 2016 and local rules. Professionals may be compensated only after application, notice to parties, and approval by the bankruptcy court. Congress set forth the standards for approval of fees and expenses in § 330. The court may allow "reasonable compensation for actual, necessary services" and "reimbursement for actual, necessary expenses." By statute, the court must weigh such factors as time spent in rendering services, customary compensation charged by comparably skilled practitioners in non-bankruptcy cases, complexity of the services rendered, and benefit to the estate. Courts may award interim compensation, but all such interim awards are subject to final review and modification at the end of the case.

There are also other provisions of the Bankruptcy Code governing compensation of third parties for making a substantial contribution to the chapter 11 estate, but those involve more narrow circumstances and are not addressed in this testimony.

Although only the bankruptcy court may approve employment and compensation, and although creditors and parties in interest may object to employment and compensation, the United States Trustee Program considers its authority to review these applications to be an important tool in carrying out its mission to uphold the integrity and efficiency of the bankruptcy system. The precise level of United States Trustee review depends upon a variety of factors, including the success of the case and participation by other parties. Review also may vary according to the size and staffing of an office. In some offices, trained paralegals may undertake an initial review, but attorneys may conduct the entire review in other offices. In addition, standard operating procedures may vary according to local practice and the circumstances of a particular case. Offices often are able to resolve many questions or disputes informally without resort to litigation. For example, some deficiencies can be remedied by supplemental disclosure. Similarly, fee reductions may be obtained prior to filing an objection or by amending the application. Furthermore, the substantive outcome may vary somewhat from district to district according to controlling case law.

The United States Trustee Program has published fee guidelines to help standardize the content and organization of applications. The centerpiece of the guidelines is a task-based billing approach by which applicants organize their time entries by discrete activities so that the costs and benefits of accomplishing specific tasks can be more easily determined.

As the Program has reported to the Subcommittee in previous hearings, we have made numerous management improvements over the past three and one-half years. Among our management advances has been institution of an automated Significant Accomplishments Reporting System by which we measure the work done in our field offices. In the future, these data should assist field office managers and the national Program leadership in setting priorities and allocating scarce resources. Although it is particularly difficult to quantify work done in the review of chapter 11 retention and fee applications, we do collect limited information.[1]

We have recently compiled our Fiscal Year 2003 data which will be published shortly and made available in an Annual Report to be distributed to members of Congress, the bankruptcy community, and the general public. Based upon data entered by our field offices, in Fiscal Year 2003, Program staff took 9,264 actions on employment and compensation applications. These actions ranged from informal negotiations to filing and arguing objections in court. A high percentage of these actions led to a successful result, including satisfactory amendment of an application or favorable adjudication by the bankruptcy judge. A total of 3,746 formal objections were filed in court. As best we can quantify the results, our actions directly resulted in fee or expense reductions of $44.8 million.

We also have compiled data for the first six months of Fiscal Year 2004. From October 1, 2003, through March 31, 2004, Program staff took 2,965 actions on employment and fee applications. A total of 1,559 formal objections were filed in court. As best we can quantify the results, our actions resulted in fee or expense reductions of $34.9 million.

Numbers alone cannot adequately convey the significance of the actions we have taken. Just as with other regulatory or enforcement agencies, our selection of the right cases and obtaining the right results may have deterrent and other salutary effects that promote the integrity of the process, including the expanded disclosure of conflicts and greater restraint on fees. Following are examples of recent cases in which the United States Trustee litigated important matters of retention and compensation of professionals.

- In *In re Pillowtex, Inc.,* 304 F.3d 246 (3d Cir. 2002), the Court of Appeals for the Third Circuit sustained the United States Trustee's position and held that the bankruptcy court could not approve an employment application until it resolved allegations that proposed counsel for the debtor had received a preferential transfer and, therefore, was not disinterested. The law firm settled the matter after remand for a six figure disgorgement.
- In *In re Safety Kleen,* Case No. 00–02303 (Bankr. D. Del.), the United States Trustee for Region 3 objected to the retention of a financial advisory firm because a principal of the firm had served as the debtor's CFO pre-petition and was connected to a lawsuit against the debtor. In a related matter arising in *In re Harnischfeger,* Case No. 99–02171 (Bankr. D. Del.), the United States Trustee moved to disqualify the same firm and for disgorgement due to its failure to disclose connections involving the firm's investment affiliate and the appointment of one of the firm's principals to the board of one of the debtors. After extensive litigation, a settlement was reached, which was approved by the court, in which the firm disgorged $3.25 million.
- In *In re Fleming Companies, Inc.,* 304 B.R. 85 (Bankr. D. Del. 2003), the United States Trustee for Region 3 objected to the fee applications of debtor's counsel. In a published opinion, the Bankruptcy Court found that the two firms had rendered services which unnecessarily generated litigation and did not benefit the estate. The court also found that the hourly rates of one of the firm's practitioners were impermissibly higher than the hourly rates charged by similarly experienced attorneys in other practice areas within the same firm.
- In *United States* v. *Schilling (In re Big Rivers Elec. Corp.),* 355 F.3d 415 (6th Cir. 2004), approximately $2.6 million in fees awarded to the examiner were disallowed based on objections filed by the United States Trustee for Region 8 and other parties. The court ruled that the examiner failed to adhere to the standards of behavior required of a bankruptcy professional and was not enti-

[1] Data reported herein include actions in chapter 7 and chapter 11 cases. Entered data exclude some reductions obtained by fee committees on which the United States Trustee is a participant. In addition, actions taken to achieve additional disclosures and fee reductions prior to filing an application are not captured in the database.

tled to any of the $2.6 million in fees originally awarded, including $960,000 in fees already in his possession which he was required to disgorge.

- In *In re Jore Corp.,* 298 B.R. 703 (Bankr. D. Mont. 2003), the United States Trustee for Region 18 moved to disqualify debtor's counsel because of counsel's failure to disclose it represented the debtor's primary lender in unrelated matters. The court granted the motion to disqualify and disallowed more than $1.8 million in fees.
- In *In re 360Networks (USA), Inc.,* Case No. 01–13721 (Bankr. S.D.N.Y.), the debtor's law firm agreed to reduce its fees by $1.35 million after the United States Trustee for Region 2 questioned the nature and manner of the firm's disclosures. In its final fee application, the firm revealed for the first time that, pre-petition, it received significant payments from the debtor that might qualify as preferential payments. The reduction in fees was approved by the court.

In recent years, the chapter 11 bankruptcy landscape has changed and new issues have emerged. This may require new approaches by the courts, United States Trustees, and others. Some of these issues are highlighted in recent chapter 11 cases associated with corporate malfeasance that occurred in the late 1990s. Other issues have emerged as law firm, business, and finance practices have evolved.

In the area of conflicts of interest and compensation, the United States Trustee is confronting dynamic situations in which new fact scenarios must be applied to established statutory and case law. Examples include the following.

- Investment banks, financial advisors, and turnaround firms often have affiliates that manage investment funds that provide financing or capital to reorganize bankrupt companies.
- Financial services firms wish to serve on creditors' committees and continue to trade in the debtor's securities. Case law does not proscribe trading, but requires, at a minimum, erection of ethical barriers.
- Professionals and other third parties increasingly seek releases and exculpation, even though the bankruptcy discharge traditionally only protects debtors and is not designed to affect claims between third parties. In *In re United Artists Theatre Co.* v. *Walton (In re United Artists Theatre Co.),* 315 F.3d 217 (3d Cir. 2003), the United States Trustee brought an action decided by the U.S. Court of Appeals for the Third Circuit. The Court held that agreements to indemnify financial advisors for their negligence may be reasonable under § 328(a).

Published reports from bankruptcy experts tell us that the spike in public company and other mega-chapter 11 filings has subsided. Although many of the largest business reorganization cases were filed in 2001 and 2002, some remain pending in bankruptcy court. The size and complexity of some of these cases are of unprecedented magnitude. The resulting fee applications are of similar unprecedented proportions. This has prompted the courts, United States Trustees, and others to consider new approaches to fee review. Among the new approaches taken have been the following.

- Courts have appointed fee examiners and fee review committees who submit periodic reports to the court with recommendations for professional compensation awards. Some of these committees have professional staff and some are comprised only of major participants in the case. Several months ago, the United States Trustee Program conducted an informal survey of our field offices and identified at least fifteen on-going fee committees.
- Automated fee review procedures have been employed in a number of cases. Courts have allowed payment to private companies that conduct computerized analysis of fee applications to identify, among other things, possible duplication of effort (e.g., multiple lawyers at meetings and inter-office conferences) and the cost of particular tasks (e.g., aggregate time expended to develop a plan of reorganization). The United States Trustee also sometimes uses an internal computer program that is effective under certain circumstances. With automated fee review systems, professionals submit data in electronic format. The computer program allows fees to be analyzed across the board for all professionals employed in the case. Full text searching allows particular entries to be identified, grouped, and totaled. Among other things, this helps identify excessive meetings and consultations among professionals in different firms employed in the case.
- Some courts require professionals to submit budgets reflecting anticipated fees and expenses so that the court, debtor, and parties may better evaluate

> the likely future course of the case and the costs of professionals. Other devices have also been employed to encourage cost-cutting, including discounts off of standard hourly rates.

These and other strategic approaches have been and ought to be continually explored by the courts, the United States Trustees, and others to enhance the quality of fee review, especially in larger chapter 11 cases. A single approach may not be effective for all cases. Cases of different size and complexity may call for different methods of review. In addition, scholarly research may assist in determining anticipated costs of reorganization. Although each case is different, compilations of empirical data may help identify excessive costs or raise red flags to prompt further inquiry of professionals whose charges exceed a normal range.

Congress has prescribed a comprehensive regimen of legal standards and procedures governing the retention and compensation of professionals employed in chapter 11 cases. Bankruptcy courts are expressly required to review and approve the employment of all professionals and the payment of all fees and expenses. The responsibility to identify non-compliance with these standards and procedures in chapter 11 cases is a responsibility shared among the courts, the United States Trustees, and other participants in the bankruptcy system. I appreciate the opportunity to discuss some of the challenges that this responsibility presents, as well as some emerging issues and possible approaches for future action.

I would be happy to answer any questions from the Subcommittee.

Mr. CANNON. Mr. LoPucki, would you give us your testimony now?

TESTIMONY OF LYNN M. LoPUCKI, SECURITY PACIFIC BANK PROFESSOR OF LAW, UCLA SCHOOL OF LAW, LOS ANGELES, CA

Mr. LOPUCKI. For the past 20 years I have been engaged in empirical research regarding big bankruptcy cases. Since about 1990, the bankruptcy courts have been competing for these cases. The competition has corrupted the bankruptcy courts and it's also been damaging the companies themselves. The easiest way to understand this is historically. In 1974 and in 1975, the Bankruptcy Rules Committee adopted liberal venue rules that in the context of big bankruptcy cases essentially allowed companies to file wherever they schose. They could pick their court.

During the 1980's the companies exercised that prerogative. The forum shopping rate, by which I mean companies filing in a district other than where their headquarters is located, increased from about 20 percent to about 40 percent. In 1990, Delaware, which had not been active at all in the 1980's—the bankruptcy court was a one-judge court with a single big case. In 1990 the Delaware court attracted two big cases; in 1991, four; in 1992, six; by 1996, the Delaware court had an 87 percent market share. That is, they got 13 of the 15 big cases filed anywhere in the United States.

That same year, the National Bankruptcy Review Commission recommended legislation to bring an end to the forum shopping. The Delaware district court revoked the reference of Chapter 11 cases that year to the bankruptcy court. It's a complicated story that I won't go into here, but by 1998—by the end of 1998, it was clear that Congress would not act on the National Bankruptcy Review Commission's recommendation. And the lawyers, and professionals throughout the United States in big cities, essentially took the matter into their own hands by pressuring the bankruptcy courts to become competitive for these cases. And the courts responded.

If you can go to the PowerPoint that will show the graph, the percentage of cases—can we get forward to that? You can see here the increase in cases over—I'm sorry, the increase in forum shopping over the past 24 years. Essentially that big peak there is when Delaware almost got all of the cases. Aside from that, it's been a steady increase. It has leveled off a little in recent years but it's leveled off at a rate of 60 to 70 percent of all the cases being forum shopped.

Going to the next graph, you can see the market shares of these courts. The New York court was dominant in the 1980's, the Delaware court dominant in the 1990's. You can see the Delaware court declining a little in recent years because the dockets are full in Delaware, and so the court is not quite as attractive as it previously had been.

Now, with the next graph, you can see these boxes that represent the 98 large public companies that came out of bankruptcy during the years when Delaware—the years that I call Delaware's ascendency from the time they started in 1990 to 1996 when they had the 87 percent market share. They did reorganize 26 companies in Delaware during that period.

Then, going on to the next graph, you can see the failure rates for those reorganizations. Within 5 years of the company emerging from bankruptcy, supposedly reorganized, 42 percent of the companies failed as compared with only 4 percent in all of the other bankruptcy courts.

You can measure failure a lot of different ways. This one measures it by refiling, the next graph measures it including companies that fail without reentering bankruptcy, and you can see it's a different proportion but still four times as high in Delaware as in the other courts.

These failures are not explained by a difference in the cases. The Delaware and New York cases are larger, but larger cases don't fail more often.

The Delaware and New York companies were not in greater financial distress. We measured about eight different ways. They were not in greater financial distress than the companies that went into other courts. They were not apparently more complex cases, as some of the lawyers argued to us. We found that they had fewer classes of creditors in their plans than the companies that were reorganized in other courts. But the failure is explained by competition. The Delaware court was faster, and faster cases failed more often. Delaware attracted prepackaged cases, and prepackaged cases failed only in Delaware. New York had high failure rates in the 1980's when it was attracting cases. When it stopped attracting cases, its failure rates fell. When Delaware came in, they came in with high failure rates. And when the other courts more recently have begun tracking Delaware, adopting the same kinds of procedures, their failure rates have gone up.

Now, there is also some other damage going on as a result of the competition. There have been, over this period of time since 1990, huge changes in the operation of the system. Some of these changes in the 1980's, there were almost no 30-day prepackage cases. You can't do a 30-day prepackage case and comply with the law. But by the 1990's, late 1990's, lots of courts were doing 30-

day prepacks. In the 1980's, CEOs—the failed CEOs—were generally forced out of office. In the 1990's they began getting retention bonuses in order to stay. In the 1980's there were very few, almost none I think, companies—sales of companies that were approved by the court without planned formalities and disclosure to creditors. By the late 1990's it was commonplace. In the 1980's there were trustees appointed in some cases. In the 1990's—after 1992 that essentially disappeared. Even in Enron, perhaps the most egregious fraud case in history, no trustee was appointed.

There were no critical vendor orders in the 1980's, but in the 1990's and by 2002 there were critical vendor orders being entered, giving preferential treatment in the hundreds of millions of dollars; in a single case in K-Mart, $200 to $300 million of preferences for some creditors over other creditors.

All of these changes are happening without any legislative amendment. Nothing big happened in this field between the eighties and the 1990's to cause this change. No legislative amendments, no judicial opinions, no policy discussions of any of these things. It's competition that is driving the change in the courts today.

Thank you.

Mr. CANNON. Thank you Mr. LoPucki.

[The prepared statement of Mr. LoPucki follows:]

PREPARED STATEMENT OF LYNN M. LOPUCKI

Mr. Chairman and Members of the Subcommittee:

I. INTRODUCTION

The Bankruptcy Courts of the United States have inadvertently been thrown into competition for big bankruptcy cases. That competition is changing bankruptcy law and practice in ways not contemplated by Congress and corrupting those courts.

By "corrupting" I mean that a substantial number of bankruptcy judges are deciding particular matters not as they believe they should, but as they believe they must to maintain the flow of cases to their courts. I can identify no particular decision as corrupt, but I can show a pattern of decisions by the bankruptcy courts for which corruption by the pressures of court competition is the most reasonable explanation. I can also show that the competition is having an adverse effect on reorganizing companies. Specifically, companies that reorganized in the courts most successful in attracting cases were two to ten times more likely to fail after bankruptcy than were comparable companies reorganized in other courts.

II. WHY BANKRUPTCY COURTS COMPETE FOR BIG CASES

Bankruptcy judges want large cases for at least three reasons:

1. For the judge, a large bankruptcy case is a career opportunity. The judge will be able to work with the nation's leading bankruptcy professionals and the proceedings will be followed by the media and the bankruptcy community as a whole. Judges who attract numerous large cases are likely to become celebrities.

2. The cases are of economic importance to the judges' communities. The court-awarded professional fees in a single, large bankruptcy case are almost invariably in the millions of dollars, and may be as high as a billion dollars (the projected estimate for the total court-awarded fees in the not-yet-completed Enron case). Fees paid without court award in these cases may be equally large. In most large cases, most fees paid will go to local professionals. Thus, attracting the case of a large company to the bankruptcy court in a city brings substantial revenues to the bankruptcy professionals in that city. Attracting all of the big bankruptcies in the United States to a single court—as the Delaware Bankruptcy Court nearly succeeded in doing in 1996—could bring billions of dollars to a local economy annually.

3. The loss of cases to other courts humiliates the bankruptcy judges, lowers their standing in their communities, and may even cost them their jobs. Most—but not all—large, bankrupt companies are linked in the minds of the public to the city in which they have long maintained a national headquarters. Examples are Enron

with Houston and Polaroid with Cambridge, Massachusetts. The bankruptcy court at that location is a sort of "natural venue" where the company is expected to file. The company that files in Delaware or New York is seen as rejecting the local court. That rejection often leads to criticism of particular bankruptcy judges for failure to take what action was necessary to retain "their" cases. To illustrate the scope of the problem, of the 24 companies headquartered in the Boston area that filed bankruptcy since 1980, only 4 (17%) filed in the Boston Bankruptcy Court. For Alexandria, Virginian, the number is 2 of 13 (15%). Some cites, including Philadelphia, West Palm Beach, and Ft. Lauderdale have lost all of their cases.

In some cases, the criticisms appear warranted. One or more of the local judges may have poor skills or temperament. In other cases, the criticisms are unwarranted. The judge is simply following laws and rules the court-selecting lawyers and executives prefer to avoid.

Bankruptcy judges are not Article III judges and do not enjoy life tenure. They serve 14 year terms and must apply for reappointment to continue in office. A recent study by Bankruptcy Judge Stan Bernstein of the Eastern District of New York found that more than 8% of the bankruptcy judges who applied for reappointment during the period 1998 to 2002 were not reappointed. Stan Bernstein, The Reappointment of Bankruptcy Judges: A Preliminary Analysis of the Present Process (unpublished manuscript October 15, 2003). Other bankruptcy judges won reappointment, but only after their competence had been challenged and they had been, in Judge Bernstein's words, "put through the wringer." Because the Courts of Appeals usually seek the opinions of local bankruptcy lawyers as part of the reappointment process, bankruptcy judges are probably more sensitive than Article III judges to how they are viewed in their communities.

III. HISTORICAL ROOTS OF THE PROBLEM

In 1974 and 1975, the Bankruptcy Rules Committee liberalized the venue rules for cases under Chapters X and XI of the Bankruptcy Code. The new rules gave corporations the option to file their bankruptcy cases at (1) the corporation's domicile or residence (later interpreted to mean its state of incorporation, (2) the corporation's principal place of business (essentially, its headquarters), (3) the corporation's principal assets in the United States, or (4) where the case of an affiliated corporation was already pending. A member of that Rules Committee informed me that at the time these rules were adopted, large public companies rarely filed bankruptcy cases and the committee was not focused on how the rule would apply to such companies. Committee members believed that if their liberal venue rules were abused, the bankruptcy courts would exercise their broad power to transfer cases to the most appropriate venues. 28 U.S.C. § 1412.

In the context of a large, public company that operates through subsidiaries in all parts of the United States, the effect of these liberal venue rules has been to allow the company to file in the bankruptcy court of its choice. The Enron case serves as an illustration. Enron Corporation was incorporated in Oregon. Enron's headquarters, and the bulk of its 25,000 employees were in Houston, Texas. Enron chose to file its bankruptcy in the New York Bankruptcy Court. (References to the "New York Bankruptcy Court" are to the Manhattan Division of the United States Bankruptcy Court for the Southern District of New York.) To accomplish that, Enron directed its New York subsidiary, a corporation with 157 employees, to file a bankruptcy petition with the New York Bankruptcy Court. A few minutes later, Enron Corporation filed in New York on the basis that the New York court was a court "in which there [was] pending a case . . . concerning [Enron's] affiliate." Numerous creditors joined in a motion to transfer Enron's cases to Houston. The New York Bankruptcy Judge denied the motion.

Through the 1980s, the rate of forum shopping (defined as filing away from the company's headquarters) in large public company bankruptcies rose from about 20% to 40%. Most of the shopping was to New York. During that decade, the Delaware Bankruptcy Court had the case of only one large, public company. That company, Phoenix Steel, had both its headquarters and its operations in Delaware. The one-judge Delaware Bankruptcy Court began attracting cases in 1990. That year it had two, including Continental Airlines. Delaware attracted four big cases in 1991 and six in 1992. In 1992, Congress awarded the Delaware Court a second bankruptcy judgeship. The Delaware Court's market share rose steadily until 1996, when 87% of the large, public companies filing for bankruptcy in the United States (13 of 15) chose the Delaware Court.

In 1996, the National Bankruptcy Review Commission adopted a recommendation designed to end the rampant bankruptcy forum shopping. That recommendation was to delete the provisions of the venue statute that authorized filing at the debtor's place of incorporation or where the case of an affiliate was pending.

In 1997, a study requested by the Judicial Conference of the United States and conducted by the Federal Judicial Center revealed that Delaware's Chief Bankruptcy Judge routinely had ex parte contacts (for scheduling purposes) with representatives of large, public companies that intended to file in Delaware, and in the course of those contacts, identified the judge that would be assigned to the case once it was filed. Seventeen days after the release of the Federal Judicial Center's report, the Delaware District Court took the unprecedented step of revoking the reference to the Bankruptcy Court of all newly-filed Chapter 11 cases. Although the District Court asserted that its action was taken merely to assist the Bankruptcy Court with its heavy docket, the action was widely interpreted as a rebuke to the Bankruptcy Court. Large, public company bankruptcy filings in Delaware declined in 1997, but resumed their rise in 1998.

By 1998, it was apparent that Congress would not act on the recommendation of the National Bankruptcy Review Commission. Over a period of two or three years, bankruptcy lawyers in at least a dozen cities, including New York, Chicago, Houston, Dallas, Los Angeles, and Miami, approached their local bankruptcy judges to request that the judges make their courts more competitive with Delaware by liberalizing their awards of professional fees and mimicking other Delaware practices. Beginning in 1999 and 2000, nearly all of the courts responded by making changes in local rules and practices, including those regarding the award of professionals fees.

By 2000, an unprecedented rise in the number of big case bankruptcy filings nationally had overwhelmed the resources of the Delaware Bankruptcy Court. The Delaware Court had been awarded its second bankruptcy judge on the basis of six big cases in 1992. In 2000, the Delaware Court attracted 45 big cases. The effect of the overload was to make Delaware a less-attractive venue. Most of the overflow went to New York. Since 2000, the Delaware Bankruptcy Court has captured 34% of all large, public company filings in the United States and the New York Bankruptcy Court has captured 20%.

IV. ADVERSE EFFECT ON REORGANIZING COMPANIES

Evidence suggests that the court competition has resulted in the destruction of many large, public companies that otherwise could have been saved. In a study of all 98 large, public companies filing bankruptcy and emerging as public companies from 1991 through 1996, Joseph Doherty and I found that 42% of Delaware-reorganized companies filed a second bankruptcy case within five years of the confirmation of their plans, as compared with 19% of New York-reorganized companies, and only 4% of companies reorganized in Other Courts. Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?,* 55 VANDERBILT LAW REVIEW 1933 (2002). Roughly twice as high a proportion of the Delaware and New York-reorganizing companies (25%) went out of business while in financial distress during that five-year period.

The high failure rates for Delaware and New York-reorganized companies cannot be explained by any salient differences in the companies choosing to reorganize in those courts. On a variety of measures, the Delaware and New York-reorganizing companies were not in worse financial difficulty than those reorganizing in Other Courts. The Delaware and New York-reorganizing companies were somewhat larger than the Other Court-reorganizing companies, but the larger companies in our study did not fail more frequently than the smaller ones. We found no significant differences by industry among the two sets of cases.

We found several indicators that the reorganization process was less effective in Delaware and New York. Although the firms filing in Delaware and New York had pre-bankruptcy earnings no lower than those of the firms filing in Other Courts, the firms filing in Delaware and New York had sharply lower earnings than the firms filing in Other Courts during the five years after they emerged from bankruptcy. Average post-bankruptcy earnings for firms emerging from Delaware reorganization were a negative nine percent. The corresponding average for firms emerging from New York reorganization was a negative three percent. For firms emerging from Other Court reorganization, the corresponding average was a positive one percent. Delaware and New York reorganizations were significantly quicker than reorganizations in Other Courts, and quicker reorganizations were generally more likely to fail. Even though the Delaware and New York-reorganizing companies were larger than the Other Court-reorganizing companies, the plans in Delaware and New York reorganizations divided the creditors into fewer classes, suggesting possible superficiality in the reorganization process.

V. ADVERSE EFFECT ON COURT PROCESSES

In addition to its obvious adverse effect on the integrity of the bankruptcy courts, the competition for big cases is also having an adverse effect on court processes. The choice of a bankruptcy court is made by the top executives of a debtor corporation. Those executives usually have little experience with bankruptcy courts and so are heavily dependent on information and advice furnished by the bankruptcy attorneys retained to represent the corporation. In some cases, financial institutions that will make post-petition loans to the debtor corporation may also play a role in selecting the bankruptcy court. Generally speaking, however, pre-petition creditors are excluded from the court selection process.

It follows that courts wishing to attract cases must appeal to the debtor's executives, attorneys, and post-petition lenders. (I refer to them collectively as the "case placers.") To make this appeal, the judges are under pressure to favor case placers on a number of key issues in the court's cases generally. The court must establish a reputation for generosity with professional fees and tolerance for the professionals' conflicts of interest. The court must approve the compensation proposed for the top executives, even when that compensation includes huge "retention" loans and bonuses for the same executives that caused the company's failure. The court cannot appoint a trustee to replace corrupt management, even in such extreme cases as Enron, Worldcom, Global Crossing, and Adelphia. The court must be willing to approve provisions in the reorganization plan that release the case placers from liability for the case placers' own wrongdoing. A judicial panel that did not yield to these pressures would not be attractive to case placers and would not get future filings.

Over the past fifteen years, the pressures of competition have resulted in major changes in the operation of the bankruptcy system. These changes were not preceded by Congressional action, appellate decisions, or even policy discussions. They evolved because the case placers wanted the changes and the bankruptcy courts stretched or broke the law to accommodate them. These are three examples of such systematic changes:

1. Thirty-day prepackaged cases. Prepackaged cases are specifically authorized in the Bankruptcy Code. A debtor "prepackages" its case by distributing a plan and disclosure statement to creditors prior to filing the bankruptcy case, and obtaining a sufficient number of votes in favor of the plan to meet the requirements of the Bankruptcy Code. Only then does the debtor file a bankruptcy case and submit the plan, disclosure statement, and ballots to the court for approval. The court can confirm a prepackaged plan only if the court first determines that the disclosure statement provided information adequate for informed voting, the plan complies with the provisions of the Bankruptcy Code, and the vote is sufficient for approval. To assist the court in that process, the Code requires that the U.S. Trustee appoint a Creditors' Committee and convene a meeting of creditors after the filing of the case.

Under the pressures of competition, some bankruptcy courts have dispensed with these two requirements—even though they have no legal authority to do so—and rubber-stamp whatever prepackaged cases are submitted to them. The creditors in these cases receive no official representation, even though there may be an unofficial committee purporting to represent their interests. By so doing, those courts make it possible for a debtor to obtain confirmation of its prepackaged plan in slightly over thirty days from the date of filing. Some of these courts have adopted local rules or guidelines directing that confirmation hearings be set thirty days after filing (Los Angeles). One court has adopted a local rule authorizing the cancelling of the meeting of creditors required by Congress in the event it cannot be completed by the confirmation hearing (New York).

Before confirming a plan of reorganization, the court is required to determine that "confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor. . . ." 11 U.S.C. § 1129(a)(11). In our study, Doherty and I found that confirmation of a prepackaged plan by the Delaware Bankruptcy Court was followed by a distress liquidation or further financial reorganization in nine of 14 cases (54%).

2. "Critical vendor" orders. The Bankruptcy Code prohibits the preferential payment of some creditors over others when both have the same legal rights. The opinions of the appellate courts are pretty much uniformly in accord. But in the mid-1990s, under the pressures of competition, some bankruptcy courts began approving preferential payments to so-called "critical vendors"—suppliers whose cooperation was needed for reorganization and who would not provide it unless the debtor paid its pre-petition debt to the supplier in full. In their early years, critical vendor orders were rare and covered only small numbers of creditors. But by 2002, critical vendor orders were being approved in most large public company cases. In some, the orders authorized preferential distributions of hundreds of millions of dollars to

hundreds or even thousands of creditors. In the Kmart case, for example, the Chicago Bankruptcy Court permitted the distribution of $200 million to $300 million in preferential payments to 2,300 supposedly "critical vendors" selected by the debtor. The Bankruptcy Court's order was reversed on appeal, but the damage was in large part irreversible because the money had already been distributed.

3. Section 363 sales. The Bankruptcy Code specifically authorizes the use of Chapter 11 to sell a company. The Courts of Appeals held that debtors may do so pursuant to a plan of reorganization after adequate disclosure to creditors and a vote, or, if the debtor has "sound business reasons" for doing so, under section 363 of the Bankruptcy Code without a plan, adequate disclosure, or a vote. Until the courts began competing for cases in the 1990s, section 363 sales of entire companies were rare.

In the 1990s, such sales became common. The competing courts so frequently and easily waived the requirement of "sound business reasons" that debtors began arranging sales and announcing those sales prior to even filing the debtors' bankruptcy cases. Since 1997, the Delaware Bankruptcy Court has given final approval to sales of seven large public companies, each in less than 50 days of the filing of the company's case. Once the bankruptcy court has finally approved a 363 sale, the sale is final. Section 363(m) of the Bankruptcy Code prohibits the reversal of that approval on appeal.

Section 363 sales of large public companies now routinely occur without adequate disclosure to creditors or the opportunity for creditors to vote on a plan. (A creditor's committee is generally appointed and consulted, but that committee often works under severe time pressure and may not be representative of creditors as a group.)

The section 363 sale procedure is fraught with potential for abuse. The case placers often have interests in the sales that conflict with those of the creditors, employees, suppliers, and taxing authorities of the debtor. The top managers may be purchasers or they may expect to be employed by the buyer. Some of the managers receive large stock bonuses from the buyer after the sale is complete. Investment bankers retained as financial advisors often recommend sales that will result in large fees to themselves; they may steer the debtor to a court that will approve the sale without question. Discovery of such abuses is difficult because the sales occur quickly, in near secrecy, and there is no legal avenue for review.

VI. SOLUTIONS

In addition to the serious adverse effects described in the preceding section, the competition for big bankruptcy cases has also had some positive effects on the bankruptcy courts. The Delaware court pioneered the development of the omnibus hearing that reduced travel expenses and inconvenience for out-of-town lawyers. That court also set a new standard for judicial availability, achieved an unprecedented level of judicial experience and expertise in the handling of large cases, and has perhaps the best-functioning PACER website in the country. Unfortunately, these benefits are far outweighed by the accompanying problems.

The essence of the court competition problem is that only a few of the many parties interested in the outcome of the case select the court. To attract cases, the courts must cater to the interests of those few, at the expense of the debtor, the creditors, and other interested parties. Allowing those other parties to participate in case selection is not practical because so much activity occurs in the first few days of the bankruptcy case. To achieve a reasonable level of efficiency in the handling of a big bankruptcy case, the issue of venue must be settled no later than on the day the case is filed.

The simplest solution would be to amend the bankruptcy venue statute to require that debtors file in their local bankruptcy courts, that is, the courts where they have their headquarters or their principal assets. Such an amendment would not eliminate all forum shopping because firms could move their headquarters or assets in the period before filing. Complete elimination of forum shopping is not, however, necessary to solve the problem. Forum shopping need only be reduced to a level at which the loss of cases by a court no longer constitutes a serious threat to the judges of that court. The integrity of the judges can take care of the rest.

An alternative solution would be to assign three or four regional courts to handle large bankruptcy cases. The law would require that all large debtors file their petitions with a single judge, along with a simple statement of facts relevant to venue. Based on that statement, the judge would assign the case to the most appropriate of the regional courts on the same day the case was filed. The advantage of this solution is that it would permit the development of large-case expertise among the judges, without forcing them to compete for the cases.

Each of the subjects discussed in this Statement is also discussed in greater detail in the manuscript of my book, *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts.* The book will be published by the University of Michigan Press in January, 2005.

Mr. CANNON. Mr. Brickman, would you please give us your testimony now?

TESTIMONY OF LESTER BRICKMAN, LESTER BRICKMAN, PROFESSOR, BENJAMIN N. CARDOZO SCHOOL OF LAW, YESHIVA UNIVERSITY, NEW YORK, NY

Mr. BRICKMAN. Mr. Chairman, I have focused my written statement on the process of administering the major bankruptcies of former producers and installers of asbestos-containing products.

Some brief history and background. Asbestos litigation today remains a high-growth enterprise. In the year 2003, more than 110,000 new claimants surfaced. That's the most ever in a single year. Though defendants and their insurers have so far paid out over $70 billion, they may have to pay out an additional $130 to $140 billion before the litigation is concluded.

The litigation has become, in my judgment, a weapon of mass business destruction which cuts ever deeper into the American industrial process and product distribution system, thus far accounting for 70 bankruptcies, plus some insurance company bankruptcies, plus additional insurance company bankruptcies that will be happening over the next several years.

In my written statement I present a brief overview of asbestos litigation drawn largely from my article on the subject published earlier this year. In it I conclude that asbestos litigation today mostly consists of a massive client recruitment effort generating claims of injury by those with no medically cognizable asbestos-related injury, supported by specious medical evidence and by litigants' testimony, which frequently follows scripts prepared by their lawyers which are replete with critical misstatements. It is thus beyond cavil that asbestos litigation represents a massive civil justice system failure and has become what I term a malignant enterprise.

An increasing amount of asbestos claiming is now being channeled through the bankruptcy process where the leading plaintiff law firms, a baker's dozen or so, exercise substantial if not near total control. Latent with boundless conflicts of interest which are largely ignored by the bankruptcy courts, this handful of law firms not only constitutes the asbestos creditor's committees, they create the bankruptcy plans, establish the criteria for the payment of the very claims that they are asserting, effectively select the trustees to operate the section 524(g) bankruptcy trusts, and constitute the trust advisory committees which have authority over trustees' actions and veto power over changes in the trust structures.

The trust distribution procedures that they create allow these lawyers to treat substantial proportions of the trust's assets as piggy banks, essentially accessible at will, irrespective of whether their claimants are actually injured or had actual exposure to a defendant's product.

In fact, for some trusts now being approved, all that is required to demonstrate the requisite exposure is for the claimant to sign a form saying "I was exposed."

Though bankruptcy trust assets already approximate $6 billion, that amount pales when compared to an additional approximately $40 billion to be added to trust assets as up to a score of companies now in the bankruptcy process create such trusts.

One effect of Congress's adoption of section 524(g) is that from the moment an asbestos bankruptcy commences, it is an overriding reality that the company will not be able to emerge from bankruptcy unless the plaintiff lawyers, representing the substantial portion of asbestos claimants, approve of the restructuring plan. The same small cadre of plaintiff lawyers who appear in most asbestos bankruptcies have thus been vested with near complete and substantially unchecked power to dictate the terms of the plan. Every bankruptcy judge understands this, and with rare exception, accepts, adopts, and otherwise ratifies whatever is needed to satisfy plaintiff lawyer demands. This unbridled power is compounded by the perverse provision in 524(g) that the 75 percent requirement be met by the number of claimants on a one-claimant/one-vote basis, not by the value of their claims.

While plaintiff lawyers hardly need any additional stimulus to sponsor additional screenings to generate additional claimants who have no asbestos-related illness, this provision does just that. Its perverseness, I suggest, is palpable.

The central conclusion I advance in my written statement is that the asbestos bankruptcy practices that I have described, coupled with some of the implementations of bankruptcy law in the bankruptcy courts that would cede this near unbridled power to plaintiff lawyers, constitutes an unprecedented assault on the integrity of the bankruptcy process.

Besides invoking its oversight role to restore both the balance and the integrity of the bankruptcy process by creating an investigatory mechanism, I recommend that section 524(g) of the Bankruptcy Code be amended to modify those perverse provisions that promote bogus claims and repose near unbridled power in the hands of plaintiff lawyers.

Finally, Mr. Chairman, I would like to request approval to supplement my written statement with the article on asbestos litigation that I earlier referenced.

Mr. CANNON. Without objection, so ordered. Thank you Mr. Brickman. I really appreciate your testimony, the testimony of all the panelists.

And I must say Mr. Brickman you were pretty direct, very thoughtful in your statements. I don't think they were overdrawn, but very direct about what the cost to society could eventually be because of this.

[The prepared statement of Mr. Brickman follows:]

PREPARED STATEMENT OF LESTER BRICKMAN

WRITTEN STATEMENT OF LESTER BRICKMAN,
PROFESSOR OF LAW, BENJAMIN N. CARDOZO SCHOOL OF LAW
OF YESHIVA UNIVERSITY

Before Subcommittee on Commercial And Administrative Law of the U.S. House of Representatives Committee On The Judiciary

July 21, 2004

Mr. Chairman and members of the Subcommittee, I am Lester Brickman, a Professor of Law at the Benjamin N. Cardozo School of Law of Yeshiva University. I want to thank the Committee for inviting me to speak at this oversight hearing on the "Administration of Large Bankruptcy Reorganizations: Has Competition for Big Cases Corrupted the Bankruptcy System?" I will focus my remarks on the process of administering the major bankruptcies of former producers and sellers of asbestos-containing products. My testimony will consist of the following:

I. Qualifications

I have had a long-standing research interest in asbestos litigation. In 1991, on the basis of knowledge and expertise that I had acquired on the subject, I was requested by the Administrative Conference of the United States, an executive branch agency of the federal government, to draft a proposed administrative alternative to asbestos litigation and to organize a colloquy to consider and debate that proposal. As stated by the Chairman of the Administrative Conference:

> [W]e asked Professor Lester Brickman to prepare a paper proposing an administrative claims solution for comment and criticism by the panel, and we look forward to comments by the audience. Let me introduce Professor Brickman, who teaches law at Cardozo Law School, Yeshiva University. He is a leading authority in the area of attorney's fees and has written numerous articles on the subject. Professor Brickman became interested in the subject of asbestos litigation some years ago when he was hired as a consultant by one of the defendants in the asbestos litigation to review contingent fee issues. He has since had the opportunity to extensively review empirical data, case files, and other materials on the subject. Because of his work in this area, we asked Professor Brickman to draft a proposed administrative solution which our panelists have been invited to criticize.[1]

Over the past fourteen years, I have devoted a substantial amount of time to research on asbestos litigation and have published four articles on the subject.[2] In these articles, I discuss the nature of asbestos-related disease; the history of asbestos litigation, including the phenomenon of the unimpaired claimant; the role of attorney-sponsored screenings; the effective hourly rates generated by contingent fee-financing of the

---

[1] Administrative Conference of the United States, Colloquy: *An Administrative Alternative To Tort Litigation To Resolve Asbestos Claims*, October 31, 1991, Transcript at 4.

[2] *The Asbestos Litigation Crisis: Is There A Need For An Administrative Alternative?*, 13 Cardozo L. Rev. 1819 (1992); *The Asbestos Claims Management Act of 1991: A Proposal To The United States Congress*, 13 Cardozo L. Rev. 1891 (1992); *Lawyers' Ethics And Fiduciary Obligation In The Brave New World Of Aggregative Litigation*, 26 Wm. & Mary Envtl. L. & Pol'y Rev. 243, 272-98 (2001); *On The Theory Class's Theories of Asbestos Litigation: The Disconnect Between Scholarship and Reality*, 31 Pepp. L. Rev. 33 (2004).

litigation and the effect of those fees on the litigation; the use and effects of forum selection; the impact of mass consolidations; and the culmination of the litigation in the bankruptcy of many former producers and sellers of asbestos-containing products and the administration of that bankruptcy process.

Finally, my qualifications as an expert on asbestos litigation, attorney-sponsored screenings, the formation and structure of asbestos bankruptcy trusts and the "trust distribution procedures" adopted by extant trusts as well as those proposed in pending bankruptcies, were confirmed after being challenged in a recent asbestos bankruptcy proceeding.[3]

II. Asbestos Litigation: An Update

Asbestos litigation remains a high growth enterprise. In 2003, more than 110,000 new claimants surfaced – the most ever in a single year. Since each claimant files claims against approximately 30-60 different defendants and bankruptcy trusts, this translates into approximately 5,000,000 new claims which will have been generated by just these claimants. While approximately 750,000 claimants have so far filed claims against over 8500 different defendants, it is estimated that 1,600,000 to 2,100,000 new claimants will yet emerge.[4] Moreover, while defendants and their insurers have so far paid out over 70 billion dollars, it is estimated that former asbestos-containing product manufacturers, owners of premises containing asbestos and their insurers will have to pay out an additional $130-$140 billion before the litigation is concluded.

[3] In re Western Asbestos Co. et al., Debtors, 2003 Bankr. LEXIS 1894 at *3 (Oct. 31, 2003).

[4] Letter from David Austern, President, Claims Resolution Management Corporation, Manville Personal Injury Settlement Trust to Hon. Patrick J. Leahy, United States Senate Committee on the Judiciary 2 (July 8, 2003) (on file with the author).

So far the litigation has accounted for approximately 70 bankruptcies including, in recent years, such companies as Owens Corning, W.R. Grace, Armstrong World Industries, Babcock & Wilcox, Federal Mogul and Combustion Engineering. I note that negotiations are currently underway in the Senate to remove the litigation from the judicial system and provide an alternative administrative resolution. No end is yet in sight, however, as what has become a weapon of mass business destruction cuts deeper and deeper into the American industrial process and product distribution system. If the litigation continues along its current path, many more bankruptcies will ensue – scores if not hundreds of companies, big and small, will almost certainly succumb as will a number of insurance companies.

III. The Need For Congressional Oversight Hearings

This hearing is taking place at a time when there is mounting evidence that the processes of negotiating and administering asbestos bankruptcies have become deeply flawed and in need of both a full scale investigation and legislative changes. I need only refer to a few of the most recent events such as the accounts in the press and elsewhere of the troubling conduct of several Advisors retained by Judge Alfred Wolin which led the Third Circuit Court of Appeals to issue a writ of mandamus removing Judge Wolin from presiding over several of the major asbestos bankruptcies now underway. In addition, there is the resignation, under fire, of Professor Francis E. McGovern from the roles of mediator and advisor in a number of these bankruptcies, accompanied by his candid admission that the system is not only "broken" but that it "is going to get worse" as well as his chilling statement, presumably in reference to the proceedings he was witnessing and participating in, including those before Judge Wolin, that "[t]here are bad things going on here."[5]

To properly assess how the bankruptcies of these and other former producers and sellers of asbestos-containing materials are being negotiated by the parties and administered by the courts, it is first necessary to have an understanding of the underlying litigation that has generated such an unprecedented number of bankruptcies and threatens scores if not hundreds of additional businesses.

IV. An Overview of Asbestos Litigation

The modern era of asbestos litigation began in 1973 when the United States Court of Appeals for the Fifth Circuit, responding to revelations of a conspiracy to suppress information regarding the hazards of asbestos inhalation,[6] allowed workers injured by exposure to asbestos to hold manufacturers of those products and others strictly liable for failure to warn that their products were unreasonably dangerous.[7] That holding enlarged what had been workers' compensation claims against employers into products liability claims against manufacturers and others.

Much of the ensuing litigation targeted the Johns-Manville Corporation, the principal miner of asbestos and the leading manufacturer of asbestos-containing material. In 1982, the company declared bankruptcy. After a protracted bankruptcy proceeding, the Manville Personal Injury Trust ("Manville Trust") was established in 1988 -- the first

5 Editorial (*St. Francis of Asbestos*), Wall St. J. June 15, 2004 at A14.

6 *See* PAUL BRODEUR, OUTRAGEOUS MISCONDUCT (1985).

7 Borel v. Fibreboard Prod. Corp., 443 F.2d 1076 (5th Cir. 1973), *cert. denied*, 419 U.S. 869 (1974).

in a succession of approximately fifteen such trusts set up after bankruptcies of approximately 70 companies thus far in the course of asbestos litigation.

To that point, most asbestos litigation involved seriously injured claimants: those stricken with mesothelioma, a deadly cancer, and serious cases of asbestosis which could also be deadly and at least were debilitating, where exposure and causation could readily be established. However, at the time of the creation of the Manville Trust, trends were already developing of plaintiffs seeking compensation based on increasingly deficient evidence of causation and injury. For example, plaintiffs advanced claims which included statements by doctors that claimants' lung conditions were "consistent with asbestosis," even though that is not a diagnosis and even though many causes other than exposure to asbestos can account for the same conditions. Plaintiff lawyers increasingly sought aggregations of claims that were of sufficient magnitude to force defendants to settle cases that they often would have won had they been individually tried, including cases that plaintiff lawyers never even would have brought but for the aggregation.

A dominant feature of asbestos claiming from the mid-1980s to the early-mid 1990s was the prevalence of pleural plaque claims. The vast majority of those with pleural plaques have no symptoms, no diminished lung capacity, no greater likelihood of developing a malignancy than similarly exposed workers who do not have pleural plaques, and also a considerably diminished likelihood of thereafter developing asbestosis than others similarly exposed who have not been found to have pleural plaques.[8] In many jurisdictions, there is no legal basis for valuing such claims since no injury has occurred. Nevertheless, tens of thousands of these claims were filed,

8 *See* Lester Brickman, *On The Theory Class's Theories of Asbestos Litigation: The Disconnect Between Scholarship and Reality*, 31 Pepp. L. Rev. 33, 51-54, 60 (2004) (hereinafter Brickman, Theories of Asbestos Litigation). The article may be accessed at www.ssrn.com/abstract=490682.

consuming hundreds of millions of dollars that would otherwise have been available to injured claimants.

A dominant feature of asbestos claiming today which has its origin in the early-mid 1990s is the enormous increase in the claims of 1/0 asbestosis by unimpaired persons.[9] This is occurring in the teeth of reports of leading medical researchers who have called asbestosis a "disappearing disease,"[10] and a condition that is "exceedingly rare."[11] Other medical researchers have stated that "we have not seen a single case of significant asbestosis with first exposure during the past 30 years."[12]

Approximately 10% of asbestos claims involve malignancies. The substantial majority of the remaining 90% allege mild asbestosis and to a lesser extent, pleural plaques.[13] Most of these claimants have no lung impairment but are characterized as having an asbestos-related injury or illness on the basis of x-ray readings by certified specialists known as B-readers. Of the 91,000 new claims presented to the Manville Trust in 2001, approximately 90% were 1/0 asbestosis claims gathered by attorney sponsored asbestos screenings. Medical reports of "consistent with asbestosis" or diagnoses of 1/0 asbestosis were presented even though there are more than 150 causes of fibrosis other than asbestos exposure.[14] Among the other causes of lung conditions which

---

9 For an explanation of asbestosis and of the significance of a 1/0 x-ray reading on the ILO scale, *see* Theories of Asbestos Litigation, *id.* at 46-51, 61-62.

10 K. Browne, *Asbestos-Related Disorders*, Occupational Lung Disorders, 3rd, 410 (1994).

11 Letter from Dr. James Crapo, Report Of The Senate Judiciary Committee on S.1125, "The Fairness In Asbestos Injury Resolution Act of 2003," July 30, 2003 at 18.

12 Jederlinic & Churg, *Ideopathic Pulmonary Fibrosis In Asbestos-Exposed Workers,* 144 Am. Rev. Resp. Dis. 695-96 (1991).

13 *See* Theories Asbestos Litigation, *id.* at 44-55, 60-62.

can be read as 1/0 asbestosis are smoking, obesity, old age, lupus, silicosis and numerous other medical conditions. Virtually all adults in the U.S. have millions of asbestos fibers in their lungs, yet suffer no adverse affects on their health. Indeed, "a sizeable portion of the adult population has lung conditions that could be diagnosed as [1/0] asbestosis."[15] One study indicates that 35.5% of a population not known to have industrial exposure to asbestos were nonetheless found to have lung conditions that could be diagnosed as asbestosis according to the standards used by the B-readers hired by plaintiff lawyers.[16]

It has now been almost 30 years since large numbers of workers were exposed to high levels of friable asbestos fibers in the course of their employment. Based upon the latency periods associated with asbestos related diseases, rates of disease manifestation should have begun to significantly decline by no later than the mid-1990s. But contrary to the predictions of medical science and despite the medical studies indicating that the vast majority of claimants are misdiagnosed and do not have an asbestos-related injury recognized by medical science,[17] asbestos litigation continues to expand at a substantial rate. The reason for this has become clear. Most current claims of injury made in the course of asbestos litigation have little to do with actual injury but rather are a function of the compensation system. If compensation is available, claims will be forthcoming. As a leading medical expert in asbestos-related diseases has stated:

> [c]laimants are being compensated for illnesses that, according to the clear weight of medical evidence, either are not caused by asbestos or do not

---

14 Hearings on Asbestos Litigation before the Committee on the Judiciary, U.S. Senate, Prepared Statement of Steven Kazan, Sept. 25, 2002, at 22 n.63 (hereinafter Kazan Statement).

15 Kazan Statement, *id.* at 25.

16 *See* Theories of Asbestos Litigation, *id.* at 107.

17 *Id.* at 103-108.

> result in a significant impairment -- i.e., are not generally regarded by the medical profession as an illness. Projection of these claims is inherently uncertain. Simply put, when medical research concludes that a condition is not caused by asbestos, or is not an illness at all, medical research will not be able to predict the number of such claims.[18]

Beginning in the mid-1980s and continuing to this day, asbestos litigation has become increasingly driven by the entrepreneurial activity of plaintiff lawyers who sponsor mass recruitment efforts by enterprises created by individuals with no background in health administration, specifically and solely to generate claims.

It is important to note the great divide between asbestos screenings and medical screenings. The latter seek to detect early signs of disease for the purpose of instituting a regime of treatment. Asbestos screenings, conversely, are not intended to and do not provide any material health benefits; rather they are intended primarily to identify and recruit "litigants." This has generated tens of millions of dollars in fees and payments to screening enterprises and the doctors they employ and billions of dollars in fees for lawyers. As one asbestos plaintiff lawyer has acknowledged, attorney sponsored mass screenings are different from the model of

> traditional toxic tort litigation [,which] follows a medical model: a plaintiff sees a doctor to treat his illness of injury and then is referred to, or otherwise finds, a lawyer. [Asbestos] screening substitutes an *entrepreneurial model:* the lawyer recruits the plaintiff -- who usually feels fine, has no symptoms or impairment, and is unaware of any "injury" -- and sends him to a screening company for an x-ray.[19]

Substantially all nonmalignant claims being brought today are generated by those screenings. So far these entrepreneurial enterprises have organized screenings of

18 Letter from Dr. James Crapo to Senator Jon Kyl, June 23, 2003, quoted in Senate Judiciary Committee Asbestos Report, *id.* at 79.

19 Kazan Statement, *id.* at 19-20 (emphasis added).

upwards of one million industrial plant and construction workers who could claim exposure to asbestos containing products at their job sites before 1972.[20] The enterprises contact union locals who cooperate in setting up screenings because they can provide union members with "a little cash to add to their retirement funds," or "to buy the fishing boat." As one screened worker noted, "It's better than the lottery. If they find something, I get a few thousand dollars I didn't have. If they don't find anything, I've just lost an afternoon."[21] With such promotional come-ons as "Find out if YOU have MILLION DOLLAR LUNGS," millions of mailings announcing the screenings have been sent out to employees and former employees promising "free x-rays" and the opportunity to cash in even though they were not sick and exhibited no symptoms. Mobile x-ray vans are brought to union halls, motels, strip malls, etc. to take x-rays at an assembly line rate of one every five minutes. A select few handfuls of B-readers and doctors cooperate with the enterprises by "diagnosing" massive numbers of those screened as having asbestosis or conditions "consistent with asbestosis." For those so diagnosed, pulmonary function tests, ostensibly to measure lung impairment, are then administered.

As part of the screening process, plaintiff lawyers retain B-readers with heightened propensities to "diagnose" x-rays taken at the screenings as indicating a grade of 1/0 asbestosis, using the International Labour Organization ("ILO") grading system. Doctors interviewed by the American Bar Association Commission on Asbestos Litigation reported having "seen hundreds or even thousands of examples of over-reading

---

[20] The operations of screening enterprises are examined in detail in Theories of Asbestos Litigation, *id.* at 62-103.

[21] Andrew Schneider, *Asbestos Lawsuits Anger Critics*, St. Louis Post-Dispatch, Feb. 11, 2003.

of x-rays for litigation purposes."[22] One doctor reviewed the medical records of 15,000 people who had been diagnosed with asbestosis based solely on x-ray readings, and determined that "only 10% of the persons could validly be diagnosed with asbestosis."[23] "Another doctor reported a 62% error rate on review of x-ray screening results previously read as 'consistent with asbestosis,'"[24] and a third doctor reviewed 22,000 asbestos-related claims and "found a presumptive x-ray review error rate of up to 86% among 5 readers, none of whose results matched the general patterns in epidemiological studies."[25]

While x-rays can reveal fibrosis, x-rays cannot measure the existence, degree or severity of pulmonary dysfunction or whether the condition is obstructive or restrictive. In addition, a complete medical examination and work history would be required in a medical setting to determine whether a fibrosis has been caused by exposure to asbestos as opposed to exposure to other dusts, such as silica or cotton dust.

Pulmonary function is measured by performance on a variety of breathing tests called pulmonary function tests ("PFTs"). These tests, when properly administered, provide objective, quantifiable measures of lung function to determine whether an individual is impaired and, if so, to what degree. They are the primary means of evaluating non-malignant asbestos-related personal injury claims and are widely used by both plaintiffs and defendants to determine the settlement values of claims and as evidence in trials.

---

22 Report of the American Bar Ass'n Com'n on Asbestos Litigation, Feb. 2003, at 10.

23 *Id.*

24 *Id.*

25 *Id.*

There is considerable evidence that PFTs administered by attorney sponsored asbestos screenings systematically and deliberately deviate from standards established by the American Thoracic Society ("ATS") in order to generate PFT results which falsely indicate pulmonary impairment.

According to testimony of screening company representatives and the B-readers and other doctors hired by plaintiff lawyers, 20-35% of those processed by attorney sponsored asbestos screenings are found to have 1/0 asbestosis. This percentage is itself evidence of systematic misdiagnosis of asbestosis. As noted, neutral medical doctors and scientists declared asbestosis a disappearing disease a decade ago. Moreover, studies done a decade ago indicate that the percentage of actual asbestosis to be found in mass screenings of industrial worker is in the range of 2.5%.[26]

On the basis of research that I have undertaken, I have concluded that the actual percentage of those screened at attorney sponsored asbestos screenings who are found positive on the basis of x-rays is in the 60-80% range and, of those, 60%-80% are found impaired on the basis of pulmonary function tests administered at the screenings.[27] This is near conclusive evidence of manifest misdiagnosis on a mass scale.

The most reasonable explanation why diagnoses of asbestosis generated by attorney sponsored asbestos screenings exceed actual rates of asbestosis by margins of 50:1-100:1 is the financial incentives that permeate the screening process. These incentives include:[28]

---

[26] *See* Theories of Asbestos Litigation, *id.* at 104-05.

[27] *Id.* at 83-90.

[28] *Id.* at 90-97.

a) The screening enterprises which generate the x-rays for B-readers and which administer pulmonary function tests operate at a furious pace since volume equals income. The resultant poor quality of x-rays renders misdiagnosis more likely since 1/0 asbestosis is itself often a highly subjective judgment. In addition, PFTs administered at screenings fail to comply with ATS standards, and frequently are misadministered both to increase the volumes of such tests in a given time period and to generate false outcomes of "impairment."

b) Some screening enterprises are paid substantially higher fees for each positive-for-asbestosis outcome they produce for the lawyers who hire them than for each negative outcome.

c) Although many B-readers charge relatively low fees per x-ray, the income that they generate in the aggregate from such readings is substantial -- in the millions of dollars for the selected few – because of the high volumes. This financial incentive has profound effects. Though there are approximately 500 B-readers in the United States, only a few handfuls have been selected to read x-rays by plaintiff lawyers. According to the Manville Trust, 49.6% of the tens of thousands of non-malignancy claims it receives that identify a doctor are based on the B-reads of just 10 doctors. These B-readers reliably find 1/0 asbestosis even though neutral readers conclude that the error rates are huge: well over 50%. B-readers who reliably read x-rays as indicating 1/0 asbestosis are rewarded with increased business. Indeed, there is specific empirical evidence that the B-readers most often selected by plaintiff lawyers conform their readings to the specific demands of the law firms that retain them. And if, in the unlikely case that "the doctor does not give the lawyer the right answer [i.e., 1/0 asbestosis], the lawyer can get a second opinion, or a third, or a fourth. . . as many as it takes."[29] Indeed, one doctor who regularly testifies as an expert for plaintiffs stated that "in some of the screenings, the worker's x-ray had been 'shopped around' to as many six radiologists until a slightly positive reading was reported by the last [doctor]."[30]

That many of the medical reports and diagnoses produced by attorney sponsored asbestos screenings lack accuracy is further buttressed by analysis of the massive shift from findings of pleural plaques to findings of asbestosis. From the late 1980s to the early 1990s, pleural plaque claims accounted for approximately 45-60% of asbestos claim volumes. Beginning by the mid-1990s, a massive shift in the mix of claimed diseases occurred. B-readers essentially ceased finding pleural plaques in x-rays and instead found 1/0 asbestosis or conditions "consistent with asbestosis." Thus they were diagnosing new claimants as having asbestosis or conditions "consistent with asbestosis," not pleural plaques, even though these claimants had worked alongside other claimants at identical work sites at the same times who were previously determined by B-readers to have pleural plaques, rather than asbestosis.[31]

The explanation for this tectonic shift in medical reporting is that, as earlier indicated, asbestos claiming today is largely a function of the compensation system, not of medical science. More specifically, the global *Georgine* settlement,[32] later invalidated by both the Third Circuit Court of Appeals and the U.S. Supreme Court,[33] included

---

29 Kazan Statement, *id.* at 21-22.

30 David Egilman, Asbestos Screenings (letter), 42 Am. J. Indus. Medicine 163 (May 2002).

31 *See* Theories of Asbestos Litigation, *id.* at 108-10.

32 Georgine v. Amchem Products, Inc., 878 F. Supp. 716 (E.D. Pa. 1994).

33 Amchem Products, Inc. v. Windsor, 521 U.S. 591 (1997), *aff'g* 83 F. 3d 610 (3d Cir. 1996).

provisions that would have effectively valued future pleural plaque claims at zero. In reaction to the settlement, other plaintiff lawyers immediately began reclassifying what would have been new pleural plaque claims as asbestosis claims -- a phenomenon that compellingly suggests that prior claimants, so diagnosed, did not have pleural plaques, and that current claimants being diagnosed with 1/0 asbestosis or conditions "consistent with asbestosis" do not have asbestosis.

Faced with the unprecedented deluge of claims generated by attorney sponsored asbestos screenings supported by B-readers' unsupportable declarations of asbestosis or "consistent with asbestosis" and systematically misadministered PFTs, as well as the enormous defense costs that were being incurred to defend against these claims in numerous jurisdictions, often simultaneously, several defendants attempted to control the rate of claiming and the expenses they were incurring by entering into agreements with plaintiff lawyers to settle their current inventory of cases and new claims, as they would arise, according to an agreed upon matrix of claim values. These attempts to tame litigation costs failed, as attorneys took advantage of lax--and even nonexistent--claiming requirements to assert hundreds of thousands of claims that lacked actual medical diagnoses and competent evidence of exposure.

V. Asbestos Litigation: A Summary of My Research Findings

On the basis of my research, I have concluded that asbestos litigation today mostly consists of:

(1) a massive client recruitment effort accounting for 90 percent of all claims currently being generated and resulting in the screening of well over 1,000,000 "litigants" in the past 15 years;

(2) generating claims of injury though most of these "litigants" have no medically cognizable asbestos–related injury and cannot demonstrate any statistically significant increased likelihood of contracting an asbestos-related disease in the future;

(3) which claims are often supported by specious medical evidence, including: (a) evidence generated by the entrepreneurial screening enterprises and B-readers – specially certified x-ray readers that the plaintiff lawyers select because they produce "diagnoses" which are not a product of good faith medical judgment but rather a function of the millions of dollars a year in income they receive for these services, and (b) pulmonary functions tests which are often administered in knowing violation of standards established by the ATS and consequently result in findings of impairment which would not otherwise be found but for the improper administration of these tests;

(4) and which claims are further supported by "litigants'" testimony which frequently follows scripts prepared by their lawyers which are replete with misstatements with regard to: (a) identification and relative quantities of asbestos-containing products that they came in contact with at work sites, (b) the information printed on the containers in which the products were sold, and (c) their own physical impairments;[34]

(5) being asserted in a civil justice system that has been altered to accommodate the interests of these "litigants" and their lawyers by dispensing with many evidentiary requirements and proof of proximate cause, giving rise to what I have termed "special asbestos law."[35]

---

34 These conclusions are documented in Theories of Asbestos Litigation, *id.*

35 *Id.* at 54-59.

It is thus beyond cavil that asbestos litigation represents a massive civil justice system failure. Indeed, in my study, I conclude that the litigation has become a "malignant enterprise."

VI. Bankruptcy: The Inexorable End Game of Asbestos Litigation

A. Introduction

An increasing amount of asbestos claiming is now being channeled through the bankruptcy process where such proceedings are largely insulated from public view. The issues are complex and newspaper coverage fails to inform the public of what is occurring which, in plainest terms, amounts to a perversion of legal process. The leading plaintiff law firms, a baker's dozen or so, exercise substantial if not near total control over the bankruptcy process. While Congress has granted the U.S. Trustee authority to select the members of the various committees, which includes the members of the "asbestos creditors committee" ("ACC"),[36] in reality, it is the leading plaintiff law firms that select themselves onto the ACC. To be sure, the U.S. Trustee does select tort creditors to be on the ACC but the practice is for those members to cede control to their attorneys through powers of attorney. The appointed members of the ACC immediately fade from view. Laden with boundless conflicts of interest which are largely ignored by bankruptcy judges and the U.S. Trustee, this handful of law firms not only constitute the asbestos creditors' committee, they create the bankruptcy plans, establish the criteria for the payment of the very claims which they are asserting, effectively select the trustees to operate the §524(g) bankruptcy trusts that will be created to actually pay the claims (with

---

36 11 U.S.C. §1102.

the approval of the bankruptcy court which virtually always is forthcoming) and constitute the Trust Advisory Committees which have authority over trustees' actions and veto power over changes in the trusts' structure. The Trust Distribution Procedures ("TDPs") they create allow these lawyers to treat substantial portions of the trusts' funds as "piggy banks," essentially accessible at will irrespective of whether a claimant is actually injured or had actual exposure to defendants' products, let alone whether the exposure was a substantial factor causing injury. In fact, in some bankruptcy TDPs, all that is required to "prove" the requisite exposure is for the claimant to sign a form saying he was exposed.

The bankruptcy trusts are being created as a result of the enactment by Congress in 1994 of §524(g), a special set of bankruptcy provisions designed to facilitate the reorganization of firms with asbestos liabilities.[37] Under these provisions, the asbestos claims against an insolvent debtor are channeled to a "trust" which is funded by equity provided by the debtor and increasingly, by the debtor's insurance coverage. As I will explain in this statement, in practice, this provision richly rewards lawyers for recruiting claimants, especially those who have no injury, let alone a lung impairment resulting from exposure to asbestos, and is further being applied in a perverse manner which subverts its purpose as well as the larger purposes of the Bankruptcy Code.

Though bankruptcy trust assets already approximate $6 billion, that amount pales when compared to an additional anticipated $40 billion to be added to trust assets[38] as up

---

[37] 11 U.S.C. §§524 (g)-(h).

[38] The actual amount to be added to these trusts may be less than $40 billion because several insurance companies which will be contributing funds to the trusts are likely to be bankrupted by their asbestos liabilities. Moreover, one or more reinsurance companies may decide to abandon the American market rather than continue to pay out huge sums for asbestos liability. Few insurance companies, if any, have established reserves sufficient to fund their anticipated asbestos liabilities.

to a score of companies now in bankruptcy, including Owens Corning, W.R. Grace, Armstrong World Industries, USG, Combustion Engineering, Congoleum, Burns & Roe, Pittsburgh Corning, Federal Mogul, G-I Holdings (the former GAF), Babcock & Wilcox, and DII Industries and Kellogg Brown and Root,[39] subsidiaries of Halliburton, establish such trusts. When that occurs, "piggy banks" with approximately $45 billion in assets will be in place which plaintiff lawyers will be able to tap essentially at will.

B. Asbestos Bankruptcy Trusts

Approximately fourteen bankruptcy trusts have been established thus far in the course of the more than 70 bankruptcies of companies faced with substantial asbestos liabilities. Most of these bankruptcies have resulted from the overwhelming number of claims as described above and the settlement postures forced onto defendants. As a plaintiff lawyer specializing in asbestos claims has observed, prior to bankruptcy defendants are often "force[d] to. . . settle. . . cases whether or not they have merit under state law."[40] Unfortunately, the advent of bankruptcy does not resolve the problem of overwhelming numbers of meritless claims. Instead, an analogous set of problems surface when these claims are presented to the trusts created in the aftermath of bankruptcies.

Because the bankruptcy trust creation process historically has been largely dictated by plaintiff lawyers, the trusts have not been structured to effectively distinguish between valid claims by plaintiffs who are actually sick as a result of exposure to

39 This restructuring plan was approved on July 16, 2004 and provides for payment of $4.2 billion into the bankruptcy trust.

40 Kazan Statement, *id.* at 20.

debtors' products and the hundreds of thousands of invalid claims brought by unimpaired asymptomatic claimants or claimants lacking significant exposure to debtors' products. Instead, these trusts have been structured to favor the interests of the lawyers controlling the creation of the trust by paying their claims earlier and at higher levels than claims which arise later in the process, without regard for merit or causation. This has resulted in the rapid depletion of trust assets.

The first and largest of the bankruptcy trusts, the Manville Trust ("MT"), was established in 1988 with the transfer of almost $2 billion in Johns-Manville assets after the latter's bankruptcy filing in 1982.

The MT was structured by the lawyers who had the greatest number of claims against the company. These lawyers were appointed to what was officially called the Asbestos Health Claimants Committee, a committee consisting of 26 plaintiff attorneys and one claimant. As noted in a very detailed and insightful examination of the Manville Trust's origin, "[b]ecause [these] committee members would take home a portion of any settlements, they had more than the usual vested interest in the bankruptcy's outcome."[41]

The stated purpose of the MT was to establish an administrative process that would deliver fair, adequate and equitable compensation to present and future asbestos claimants without the need for litigation. This goal was to be effectuated by the Manville Trust Distribution Procedures ("MTDP"), which provided that claimants would be paid a fixed sum in accordance with the classification of the condition upon submission of minimal proof of exposure to a Manville product and the existence of an asbestos related medical condition. Thus, the MT was structured in favor of ease of filing at the expense

---

41 Amy Singer, *Leon Silverman, His Clients, The American Lawyer,* Oct. 1990, at 58, 60.

of accuracy in claiming. This accorded with the interests of the plaintiff lawyers who structured the MT. They had devised a plan which "was doomed to fail,"[42] but which would reward them with enormous fees. Moreover to facilitate this plan, these plaintiff lawyers selected the then executive director of the Association of Trial Lawyers of America to head the MT.

The immediate consequence of a structure devised by plaintiff lawyers and run by a representative of the plaintiff lawyers was a feeding frenzy. Funds were paid out so precipitously that the MT, after distributing $677,445,619, quickly became insolvent and itself required restructuring. The fund payout generated huge rewards for the lawyers who were first in line, most especially those who controlled the process of creating the trust. Of the aggregate payout, plaintiff lawyers received approximately $266 million. I have estimated that the effective rate realized by those plaintiff lawyers was $5,000 per hour, even though those claims were, for the most part, not disputed in the trust process, were settled in batches of hundreds or thousands and involved little risk for the lawyer.[43] Even under the reorganized MT, where attorney fees were capped at 25%, I have estimated that plaintiff lawyers averaged $1,500-$2,750 per hour for filing what were essentially administrative claims.

The effect of the failure of the MT to have created a structure and trust distribution procedures to distinguish between valid claims and those that lacked merit was further amplified by the *Georgine* settlement.[44] As indicated, that settlement led

---

42 *Id.* at 58

43 *See* Lester Brickman, *The Asbestos Litigation Crisis: Is There A Need For Administrative Alternative?*, 13 Cardozo L. Rev. 1819, 1835 n.61. No plaintiff lawyer, to my knowledge, has taken issue with my calculated as find.

44 *See supra* note 32.

plaintiff lawyers to reclassify pleural plaque claims as mild asbestosis claims. The MT soon experienced dramatic increases in the number of claims of unimpaired persons alleging 1/0 asbestosis, forcing it to decrease its payout to five cents on the dollars.

As reported by the MT Trust, "90% of the Trust's last 200,000 claims have come from attorney sponsored x-ray screening programs. . . 91% of all claims against the Trust allege only non-malignant asbestos 'disease,' and. . . these cases currently receive 76% of all trust funds."[45]

One researcher has calculated that the MT may have paid $190 million for unauthentic or inflated claims between 1996 and 2001.[46]

Based upon my studies of fourteen asbestos bankruptcy trusts, I conclude that these trusts have failed to meet what is (or ought to be) their fundamental purpose: ensuring that the limited resources available from the estate of the bankrupt debtor are allocated fairly to persons who suffered actual injury caused by exposure to the debtor's products. Instead, it is clear from my research that major portions of these assets have been diverted to the payment of claims of those without injury and those whose injuries were not caused by exposure to the debtors' products, with as much as 40% of those payments going to plaintiff lawyers. These assets are being dissipated at the expense of the actual victims injured by exposure to the debtor's products, who are being victimized a second time by the trusts' failures. I attribute the asbestos bankruptcy trusts' failures to five basic flaws:

---

45 Letter from Steven Kazan to Honorable Jack B. Weinstein and the Honorable Burton Lifland, July 23, 2002 (reporting remarks by David Austern at an asbestos seminar), included as Attachment A to Judiciary Committee Asbestos Report, Remarks of Senator Kyl.

46 *See* Roger Parloff, *Mass Tort Medicine Man*, The American Lawyer, Jan. 3, 2003.

a) failure to provide for independent trustees and disinterested administrators;
b) failure to establish appropriate medical criteria in the trust distribution procedures;
c) failure to require reliable diagnoses of disease by independent qualified medical personnel;
d) failure to require adequate evidence of exposure to debtors' products; and
e) lack of appropriate and effective audit and oversight procedures.

Because of these flaws, bankruptcy trusts have been overwhelmed by hundreds of thousands of meritless claims, resulting in rapid dissipation of trust assets and loss of meaningful compensation for actual victims injured by exposure to debtors' asbestos-containing products.

The MT has been the model for enactment of §524(g) of the Bankruptcy Code and for the establishment of other asbestos bankruptcy trusts. The intrinsic flaws of the MT have thus been replicated both in legislation and in other bankruptcy trust practices. This represents a massive failure in civil justice administration. In the following sections, I will explore the dimensions of, and reasons for, this failure.

C. The Effect Of The Adoption Of Section 524(g) Of The Bankruptcy Code

In a conventional Chapter 11 case, a debtor files for bankruptcy in order to begin the process of negotiating with its creditors over a plan of reorganization. The end result is a reorganization plan which sets forth the recovery that each class of creditor or stockholder will receive and allows the company to emerge as a viable entity. For a reorganization plan to be adopted, it must normally be approved by a two-thirds majority of each class of affected creditors or stockholders. However, the bankruptcy court may approve a reorganization plan over the objection of a creditor or stockholder class if the court concludes that the plan is "fair and equitable" to the class. Parties entitled to vote on a plan are identified through a process that requires all creditors to assert their claims by a court-designated "bar date."[47] Claims not filed by that date are forfeited. In asbestos-related bankruptcies, the "bar date" takes on critical importance. This is so because asbestos-related diseases have long latency periods; many victims, therefore, do not know at the time of the bankruptcy that they will have claims to assert against that company and would thus be dispossessed of their claims upon manifestation of injury.

The early asbestos bankruptcies, beginning with the Manville Trust, generally solved the problem of these future claims by estimating the amount of these future claims and funding a trust with assets intended to provide those claimants with recoveries similar to those being received by current creditors. Because the trusts' assets would include equity in the debtor, it was to the advantage of present claimants looking to the trust for payment that the company emerging from bankruptcy be insulated from future claimants. To accomplish this, bankruptcy courts issued "channeling injunctions," which required future asbestos claimants to sue the trust rather than the reorganized company.

To resolve doubts about whether the bankruptcy courts' inherent powers were broad enough to issue such a channeling injunction, in 1994, Congress created explicit statutory authority for channeling injunctions in asbestos cases: Section 524(g). One of its provisions -- with consequences that Congress could not have intended -- increased the usual two-thirds requirement to 75% of those claimants with allowed claims to be paid under the plan from the assets of the trust.[48] The legislative change did not directly address another section of the bankruptcy code which gives courts significant leverage in bringing parties to agreement on a plan of reorganization. As noted, under bankruptcy

---

[47] 11 U.S.C. § 3003(c)(3).

[48] 11 U.S.C. §524(g)(2)(B)(ii)(IV)(bb).

law, if one class votes the plan down, the plan can still take effect if the judges finds that it is "fair and equitable" – a process known as "cramdown."[49] Cramdown limits the ability of a creditor group to hold up the bankruptcy to obtain a disproportionate and economically unjustified amount. It is the threat of cramdown that keeps parties honest, pressures then to resolve their differences at the bargaining table, and allows the company to reorganize without protracted delays. Bankruptcy courts appear to operate under the assumption that §524(g) exempts asbestos claimants from cramdown.[50] Exemption thus far from cramdown coupled with the 75% supermajority provision has drastically shifted the balance of forces vying for share of the debtor's assets. From the moment an asbestos bankruptcy commences, it is an overriding reality that the company will not be able to emerge from bankruptcy unless the plaintiff lawyers representing the substantial portion of claimants approve of the restructuring plan. The same small cadre of plaintiff lawyers who appear in most asbestos bankruptcies have thus been vested with near complete and substantially unchecked power to dictate the terms of the plan. Every bankruptcy judge understands that this is so and with rare exception, accepts, adopts and otherwise ratifies whatever is needed to satisfy plaintiff lawyer demands, including grossly inflated demands[51] and trust structures and trust distribution procedures that allow claims to be

---

49 11 U.S.C. §1129 (b).

50 *See* Walter v. Celotex, 197 B.R. 372 (Bankr. M.D. Fla. 1996) (though not specifically addressing the cramdown point, the court agreed that Celotex's attempt to circumvent the 75% voting requirement violated §524(g). The decision cites Ralph Mabey & Peter Zisser, *Improving Treatment of Future Claims: The Unfinished Business Left By The Manville Amendments*, 69 Am. Bankr. L.J. 487 (1995) which mentions in passing and without authority that §524(g) precludes cramdown. Though the court stated that "the determination as to the scope and the extent of a §524(g) injunction is limited to the determination of what was required by the [settlement agreement]," *id.* at 379, nonetheless, the decision is relied on by asbestos creditors to support their argument that §524(g) precludes cramdown.)

51 For example, plaintiff lawyers are demanding the enormous sum of 16 billion dollars as a condition for allowing Owens-Corning to emerge from bankruptcy. In the Federal-Mogul bankruptcy, they

paid without valid evidence of actual injury and without proof of actual exposure to the debtor's products.

This unbridled power is compounded by the perverse provision in §524(g) that the 75% requirement be met by the number of claimants with allowed claims to be paid under the plan, on a one-claimant-one-vote basis, not by the value of their claims. While plaintiff lawyers hardly need any additional stimulus to sponsor additional screenings in order to generate additional claimants – the overwhelming majority of which have no asbestos-related illness cognizable by medical science – this provision in §524(g) does just that. The more claimants lawyers can thus generate, the more control they can exert over the bankruptcy process and the more they can extract from the company in the way of a pre-petition "success fee" for facilitating the 75% approval. The perverseness of this provision is thus palpable. However incongruous it may be to contemplate that Congress is providing lawyers with rewards commensurate with the number of bogus legal claims that they can originate, that is exactly the outcome under §524(g) today. Under one-claimant-one-vote, a nonsick claimant who has been "diagnosed" by one of the plaintiff litigation doctors as having a condition "consistent with asbestosis" (though not with asbestosis), who has no lung impairment even under maladministered pulmonary function tests performed by a screening enterprises, has the same "one vote" as a claimant with mesothelioma, a gruesome and deadly disease with a value in the tort world of several million dollars. Since nonsick claimants outnumber and outvote malignant claimants and others who are actually ill by a ratio of 8-10:1, the latter typically end up shortchanged in the asset division by a wide margin. Section §524(g) as

are demanding over one billion dollars despite the fact that prepetition, the company's total payout for asbestos claims was less than twenty million dollars.

applied, thus favors the interests of the nonsick over the claims of those with malignancies. No members of Congress, not even card-carrying members of the American Trial Lawyers' Association, would knowingly vote to enshrine such a policy. Yet, by the law of unintended consequences, this is precisely the policy that Congress has adopted.

Section 524(g) also mandates that the reorganized company issue a majority of its voting stock to the trust established to pay claimants. The practical effect of this provision is that when the reorganized company emerges from bankruptcy, the corporate officers will be working for the plaintiff lawyers who control the bankruptcy and through their designees, the trustees of the trust, will control the majority of shares of the reorganized company. This has the obvious effect of deterring these officers from opposing plaintiff lawyers by, for example, seeking to restrict claiming eligibility against the trust to those with actual asbestos-related injuries that have resulted from exposure to the debtor's products.

What Congress has inadvertently created -- a perverse discriminatory process that promotes fraudulent claiming -- Congress should now correct.

D. Pre-Packaged Bankruptcies

Increasingly companies which are overwhelmed by asbestos litigation and facing insolvency, are resorting to pre-packaged bankruptcies ("pre-packs"). In a pre-pack, the Chapter 11 plan is negotiated between the attorneys for the asbestos claimants and the debtor-to-be and voted on before the company files its bankruptcy petition. [52] Usually, the court than holds a single hearing to determine whether the requirements of the Bankruptcy Code have been adhered to and whether the plan should be approved.[53]

There is nothing inherently wrong with the concept of a pre-packaged bankruptcy filing. Indeed, pre-packs may be seen as a way to take advantage of the special "asbestos trust" and "channeling injunction" provisions of the Bankruptcy Code to efficiently provide fair compensation to individuals injured as a result of exposure to asbestos products in a process which minimizes litigation and transaction costs, expedites payments to claimants and preserves to the maximum extent possible, the debtor's business and goodwill.[54] Indeed, companies that have resorted to pre-packs such as Shook & Fletcher Insulation Co., J.J. Thorpe Company and Combustion Engineering, Inc., indicate that they are doing so for purposes of fairness, efficiency and avoidance of delay.[55] Prepacks have also been filed by ACandS, Western Asbestos Co., Mid-Valley (involving certain Halliburton subsidiaries including DII Industries, LLC, formerly Dresser Industries, and Kellogg, Brown & Root), Utex and the Congoleum Corporation.[56] Despite the stated advantages and objectives of pre-packaged bankruptcy filings, the

---

52 *See* United Artists Theatre Co. v. Walton, 315 F.3d 217, 224 n.5 (3d Cir. 2003) (distinguishing pre-packs from "pre-approved" bankruptcies and conventional bankruptcy cases); In re NRG Energy, Inc., 294 B.R. 71, 82 (Bankr. D. Minn. 2003) (citing additional cases and articles on pre-parks generally).

53 *See generally*, Mark D. Plevin et al., *Pre-Packaged Asbestos Bankruptcies: A Flawed Solution*," 44 S. Tex. L. Rev. 883 (2003) (hereinafter Plevin et al., Pre-Packaged Asbestos Bankruptcies).

54 *Id.* at 889-91.

55 *Id.*

56 In the interest of full disclosure, I was retained for a short time as a potential expert witness on the history of asbestos litigation, formation of asbestos bankruptcy trusts and the effect of the proposed TDP with regard to the Congoleum bankruptcy. Other than reading the proposed Congoleum Plan and related documents, I did no other work.

practices that have developed reveal serious distortions and perversions of the bankruptcy process.

To illustrate how pre-packs actually come into being, I have extracted elements from various pre-packs that have been negotiated to create the following composite example:

1. A Pre-Pack Composite

Because of bankruptcies of companies that had provided a substantial portion of the cash flow realized by plaintiff lawyers, a former asbestos-containing product producer ("FAPP") finds that plaintiff lawyers are no longer willing to settle 1/0 asbestosis claims for $300 per claim, as they had been doing for several years and are now demanding $1500 for such claims and proportionately higher amounts for seriously injured claimants. In addition, FAPP is being named as a defendant in an increasing number of cases.

FAPP's *denouement* comes when it is taken to trial in a "magic" jurisdiction.[57] Though the three plaintiffs in that action have no asbestos-related injury recognized by medical science, have never sought medical treatment for their condition and have never missed a day of work due to adverse health, the jury awards each $20,000,000. Plaintiff lawyers then approach FAPP and indicate they are willing to settle the verdicts at a discount but only if FAPP agrees to settle several hundred similar claims that are in plaintiff lawyer's inventory. (The same scenario may occur where a single plaintiff with a malignant condition goes to trial in a "magic jurisdiction" and compensatory and punitive damages, for example, of $50,000,000 are awarded. In that case, to settle the

[57] *See* Theories of Asbestos Litigation, *id.* at 39 n.17.

malignant claim, plaintiff lawyers require inclusion of scores or more of nonmalignant "unimpaired" claims.).

As a consequence of these recent verdicts and increased settlement demands, FAPP's stock plunges, eliminating the value of stock options of officers and board members. FAPP has now also gotten the message that even though it has almost a billion dollars of insurance coverage remaining (though that is disputed by the insurance carriers), the quintupling of the price for settling claims coupled with a substantial increase in the number of claims, both realized and anticipated, will put its economic viability at risk. FAPP is then approached by plaintiff lawyers (or initiates the contact on its own) to discuss a global settlement of its asbestos liability. In the course of those negotiations, FAPP agrees to the following:

1) hire a law firm designated by plaintiff lawyers with which they frequently work in tandem to represent FAPP during the course of negotiations so as to "facilitate" those negotiations;

2) do a pre-packaged bankruptcy filing;

3) separately settle a large number of plaintiff lawyer's pending cases for highly inflated values, to be paid out of its insurance coverage;[58]

4) agree to a reorganization plan ("plan") which is largely drafted by plaintiff lawyers and the law firms that FAPP hired at the "suggestion" of the plaintiff lawyer; and

5) pay a "success bonus" of $20,000,000 to the plaintiff lawyer for obtaining the 75% claimant approval required to create a §524(g) trust.

[58] In a two part structure that has now become commonplace in pre-packaged asbestos bankruptcies, Congoleum has agreed to establish a prepetition trust funded by insurance proceeds to distribute funds in accordance with the terms of its settlement agreement with claimants and has granted that trust a security interest in its rights under applicable insurance coverage and payments from insurers for asbestos claims. Plevin et al., Pre-packaged Asbestos Bankruptcies, *id.* at 891-92.

As part of this plan which includes assignment of its remaining insurance coverage to the bankruptcy trust to be created, FAPP will be allowed to retain a substantial portion of its assets (but less than 50%)[59] as it emerges from bankruptcy.

FAPP is largely uninvolved in formulating the plan drawn up by its ostensible counsel and the plaintiff lawyers despite the fact that it allows claimants who have no injury recognized by medical science and who will not be required to present any proof of actual exposure to its products,[60] to be paid by the trust to which claims will be channeled. FAPP's indifference to the terms of the plan reflect the economy realities of the situation. It has no interest in whether the claims against the trust will be valid. Its only concern is to get the 75% claimant approval of the plan so that upon its emergence from bankruptcy, an injunction will issue channeling all claims for injury arising from alleged exposure to its products to the trust.[61] To facilitate the 75% approval, as directed by the plaintiff's lawyer, FAPP agrees to pay (or to assign its insurance coverage to pay) 95% of the liquidated amounts of the separate highly inflated settlements of plaintiff lawyers' current inventories. By that artifice, which leaves a 5% unpaid stub, plaintiff lawyers will still be able to cast votes in favor of the plan for those claimants who have settled their claims but are being paid "only" 95% of those settlement amounts.[62]

---

59 11 U.S.C. §524(g)(2)(B)(i)(III).

60 The reorganization plan filed in the Congoleum bankruptcy allows claimants to file against the trust on the basis of minimal medical criteria by submitting the following exposure statement: "I [client's name], under penalty of perjury, state that I was exposed to an asbestos-containing product manufactured, sold or distributed by Congoleum or for which Congoleum has legal liability." Thus, someone who once walked across a Congoleum tile for one minute can honestly sign this statement to qualify for payment. Indeed, under the proposed plan, essentially anyone in the United States can qualify for payment so long as they can provide the most basic of medical information.

61 11 U.S.C. §§524(g)(1)(A)-(B), 3, and 4.

62 In the "master settlement agreement" setting up the Combustion Engineering Settlement Trust, three classes of claims were created. One class was to be paid 95% of the agreed settlement amounts with

2. Pre-Packaged Asbestos Bankruptcies: An Assessment

The experience to date with pre-packaged asbestos-related bankruptcies is disturbing if not alarming. The points I raise below only touch upon a limited number of the most germane issues. On the basis of the research I have so far undertaken, it is manifest that a more complete study is called for. I therefore urge this Committee to commission such a study to determine whether the integrity of the bankruptcy process has been compromised by the practices that have developed with regard to pre-packaged asbestos bankruptcies.

1) An overriding purpose of the Bankruptcy Code is to treat like claimants alike.[63] However, because pre-pack negotiations take place in secret, select groups of claimants whose lawyers are part of or know about the negotiations are able to receive more favorable treatment than other similarly situated claimants. Such discriminatory actions would be objectionable in any context but are especially objectionable because some of the targets of the discrimination are persons who have suffered actual injury.[64]

This was the case in the ACandS bankruptcy. There, Chief Judge Randall J. Newsome, to this point perhaps the sole bankruptcy judge apparently willing to incur the ire of plaintiffs lawyers by applying the requirements of the bankruptcy code to asbestos bankruptcies, struck down the prepackaged bankruptcy plan, stating:

---

the remaining 5% "stub" remaining as a claim to be asserted in the bankruptcy case. The second class was to be paid 85% with a 15% stub to be asserted in the bankruptcy case and the third class was to paid 75% with a 25% stub remaining. Plevin et al., Pre-Packaged Asbestos Bankruptcies, *id.* at 900.

63 "[A] plan shall. . . provide the same treatment for each claim or interest of a particular class. . . ." 11 U.S.C. §1123(a)(4).

64 For example, in the Combustion Engineering matter, while the favored creditors – the overwhelming majority of which have no asbestos-caused illness recognized by medical science – have received a pre-petition payment as high as 95 cents on the dollar (plus an additional recovery in bankruptcy), cancer victims, 291 of whom are opposing the plan, as well as all future claimants, are to receive an estimated 18 cents on the dollars.

> Section 524(g)(2)(B)(ii)(V) empowers the asbestos trust to manage present and future claims through various mechanisms, but those mechanisms must "provide reasonable assurance that the trust will value, and be in a financial position to pay, present claims and future demands that involve *similar claims in substantially the same manner*." (Emphasis added.) The trust established in ACandS' plan of reorganization does nothing of the kind. Not only does the plan discriminate between present and future claims, it pays similar claims in a totally disparate manner by giving preferential treatment to certain claimants who are secured by insurance proceeds. Those security interests were not granted based upon the medical condition of those claimants, but rather because, for whatever reason, they were first in line and able to carve out seemingly unassailable security interests. Nothing could be further from what the drafters of § 524(g) intended, as is evident from the legislative history. . . .
>
> It is also impossible to conclude that this plan is imbued with fundamental fairness. Although the plan may meet the technical classification requirements of § 1122 and § 1129(b), it is fundamentally unfair that one claimant with non-symptomatic pleural plaques will be paid in full, while someone with mesthelioma runs the substantial risk of receiving nothing. Both should be compensated based on the nature of their injuries, not based on the influence and cunning of their lawyers. ***The court is informed that other judges have confirmed plans with such discriminatory classifications. This judge cannot do so in good conscience.***[65]

2) The discriminatory treatment referred to by Judge Newsome is a common if not ubiquitous feature of pre-packaged bankruptcies. Usually, there is a pre-petition trust that pays a subset of current claimants nearly full value for their claims, followed by a post-petition trust that pays other current claimants and future claimants much smaller percentages of their claims, with significantly more stringent qualifying requirements.[66] This discriminatory treatment financially benefits the lawyers for the preferred claimants who typically charge contingency fees of 40 %. This benefit is spelled out in a recent law journal article:

---

[65] *In re* ACandS, Inc., Debtor, 2004 WL 1354283 (Bankr. D. Del) at *5-*6 (emphasis added).

[66] *See* Plevin et al., Pre-packaged Asbestos Bankruptcies, *id.* at 912.

> Because their clients get paid more, and sooner, than other claimants, these lawyers personally benefit when the plan is structured in such a fashion. If the plan treated all claimants the same, paying all current claimants through the mechanism of a post-petition trust, the lawyers for the current claimants would make less money—even assuming the bankruptcy court or the trust made no effort to restrict the portion of a trust beneficiary's payment that could be paid as a contingent fee. This, as much as anything, explains why asbestos pre-packs are structured in such a Byzantine fashion that is so different than any "conventional" asbestos bankruptcy case.[67]

3) The realignment of interests in a prepackaged bankruptcy filing threatens the integrity of the bankruptcy process. The debtor, in some cases, is effectively coerced by the plaintiff lawyers to abdicate all responsibility for negotiating the plan and to join forces with the plaintiff lawyers to fund the trust solely or substantially with insurance coverage. Once again, it is Judge Newsome who has belled that cat:

> The plan under consideration falls short. . . [of the required] standard [of good faith] in nearly every respect. Although ACandS was represented during the course of the prepackage negotiations, the correspondence among plaintiffs' asbestos counsel presented at trial indicates that the plan was largely drafted by and for the benefit of the prepetition committee. It was the prepetition committee that drafted (or more likely directed debtor's counsel in drafting) the prepetition trust, and apparently chose the trustee for the trust; it was the prepetition committee that decided how the security agreement would be crafted and how many classes of security interests would be formed; and it was the prepetition committee that decided who was going to get what. . . . ACandS was there to do their bidding, having been thrown overboard by Irex [its parent] to keep what was left of that company afloat. Given the unbridled dominance of the committee in the debtor's affairs and actions during the prepetition period, its continued influence flowing from its majority status on the postpetition creditors committee, and the obvious self-dealing that resulted from control of the debtor, it is impossible to conclude that the plan was consistent with the objectives and purposes of the Bankruptcy Code.[68]

---

[67] *Id.*

[68] *In re* ACandS, *id.* at *6.

4) Another consequence of a pre-packaged filing is that the number of claims will jump as plaintiff lawyers pile on in pursuit of trust assets. For example, in its pre-petition financial statement, Congoleum disclosed that before it started to pursue a pre-packaged plan, the company had an asbestos claim dismissal rate in the 60-90% range and that settled claims averaged about $340.[69] In addition, its SEC disclosures projected the value of asbestos claims over the following fifty years to be in the $53 to $195 million range.[70] After announcing its intent to file a pre-packaged plan, the number of claims almost doubled and the company's estimate of total projected payments increased to approximately $1 billion – virtually all of which was to paid from insurance coverage.

5) The effects of the power conferred on plaintiff lawyers by §524(g) and interpretations of the Bankruptcy Code by bankruptcy courts are well illustrated in the prepackaged bankruptcy filing of Combustion Engineering. In that matter, the parent of Combustion Engineering agreed to pay Joe Rice of Motley Rice a "success fee" of $20,000,000 for facilitating the filing. Since Rice presumably represented clients with claims against Combustion Engineering, he was, in effect, accepting a fee from the adversary of his clients for settling his clients' claims -- a glaringly unethical arrangement that has nonetheless received the approval of the U.S. District Court.[71]

6) In pre-packs, the debtor and the plaintiff lawyer together select a futures representative, arrange the terms of his compensation and retain the right to hire and fire him. While there is considerable reason to doubt that selection of a futures representative

---

69 *See* Annual Report, Congoleum Corporation, 2001, at 8-9.

70 *See* Asbestos Liability Summary Memo prepared for Congoleum by Ernst & Young at 2, March, 2002, included in Congoleum Summary Review Memorandum, Dec. 31, 2001, filed with the SEC.

71 *See infra* section VI.E.3.

in a conventional asbestos bankruptcy is a sufficient protection for future claimants,[72] it is clear that in a prepackaged bankruptcy, the process is simply broken. In that circumstance, the futures representative is charged with negotiating with the same people who hired him and on whom he depends for his future employment. As a reward for "successfully" discharging his duties in the negotiation of the pre-packaged plan, plaintiff lawyers and debtors now in concert, will propose to the bankruptcy court that this hand-picked designee of the parties with interests fundamentally conflicting with those of future claimants, should be appointed by the bankruptcy court as the futures representative under the provisions of §524(g). That these courts then give their imprimatur is compelling evidence that bankruptcy courts and the U.S. Trustee are abdicating responsibility to exercise oversight over the selection of future claims representatives.

E. Conflicts of Interest

Conflicts of interest abound throughout asbestos litigation. In an article I am currently writing on the subject, I acknowledge that the effort I am undertaking to identify ethical issues in asbestos litigation may be largely academic . Indeed, if the reigning lawyers' code of ethics, The Model Rules of Professional Conduct, were to be amended to include the provision: *These Rules shall not apply to asbestos litigation,* it is doubtful whether there would be a substantial change in current litigation practices.

---

72 *See infra* section VI.E.1.

Conflicts of interest arise in asbestos litigation because present as well as future claimants are competing for a finite and insufficient quantum of assets, and are therefore in effect, engaged in a zero-sum game. Accordingly, law firms which represent large numbers of asbestos claimants and which recruit new claimants who will be actively competing for limited resources simultaneously with the firm's current clients are violating Model Rule 1.7 by failing to secure the informed consent of both new and current clients to these conflicting engagements. Conflicts of interest are also created by the common practice of representation of a diverse disease mix. Nonetheless, courts and disciplinary authorities largely ignore conflicts of interest in asbestos litigation, even when the violations are egregious.[73]

The conflicts of interest that abound in asbestos litigation exist in even greater profusion in the asbestos bankruptcy process. Here conflicts of interest are, at least in theory, subject to the special purview of both bankruptcy courts and the U.S Trustee. Bankruptcy courts, however, largely ignore such conflicts, choosing expedient submission to the power exercised by plaintiff lawyers over exploration of conflicts and enforcement of the bankruptcy rules. While in significant measure, it is the role of the U.S. Trustee to inhibit conflicts of interest,[74] form creditors' committees and insist upon full disclosure of even potential conflicts, that role has been considerably diminished in practice. One reason is that the tort claimants that the U.S. Trustee appoints to the ACCs effectively resign their roles when they give their proxies to their attorneys, notwithstanding their own fiduciary duties to creditors. Plaintiff attorneys, who then constitute the ACC, have effectively overridden the U.S. Trustee's statutory obligation to

73 *See* Theories of Asbestos Litigation, *id.* at 72 n.109.

74 *See* 28 U.S.C. §586(a)(3)(H); *see also*, 11 U.S.C. § 307.

appoint ACC members. This displacement facilitates these attorneys' failure to disclose to the U.S. Trustee the conflicting interests that they represent.

While a full treatment of conflicts of interest in asbestos bankruptcy is not possible within the time constraints under which I am operating, the following recitation should be sufficient to alert this Committee and the U.S. Trustee, as well, of some of the principal conflicts.

As already noted, the same law firms that represent the large majority of asbestos claimants also represent the majority of claimants in bankruptcy proceedings.[75] Among the claimant/creditors these law firms represent in a bankruptcy, a relatively small percent list malignancies such as mesothelioma, lung cancer and other cancers. The large majority allege pleural plaques and mild (1/0) asbestosis. These nonmalignant claims include both those alleging impairment on the basis of pulmonary function tests typically administered during attorney-sponsored asbestos screenings,[76] and those who do not allege impairment -- the so-called "unimpaireds." Because of the zero-sum nature of the bankruptcy process, each grouping of claimants has differing interests. In particular, the malignant subgroups (mesothelioma, lung cancers and other cancers) have interests which conflict with the nonmalignant subgroups. These conflicts of interest are magnified by the routine failure to comply with Bankruptcy Rule 2019(a) which requires that any entity purporting to represent more than one creditor in a Chapter 11 case "shall

75 A memorandum filed in the Owens Corning ("OC") bankruptcy estimates that the handful of law firms listed above represent over 100,000 asbestos claimants in the OC bankruptcy proceeding. Moreover, prior to the filing of the OC bankruptcy, approximately 111 law firms said that they represented approximately 235,000 claimants; of these, 10 law firms represented approximately 120,000 of these claimants. *See* Memorandum In Support of Motion For Structural Relief Required To Eradicate the Legal Ethical Conflicts of Asbestos Law Firms (filed by Official Committee of Unsecured Creditors), Oct. 24 2003, In Re Owens Corning et al., U.S. Bankr. Ct., D. Del., Case No. 00-03837 (JKF).

76 For a discussion of such testing, *see* Brickman, Theories of Asbestos Litigation, *id.* at 111-28.

file a verified statement" listing the name and address of each creditor and the nature and amount of each creditor's claim.[77]

In addition to conflicts of interest between current claimants represented by the same law firms, there are also conflicts of interest resulting from the representation of those current claimants while at the same time actively recruiting new claimants to compete for the limited resources. The U.S. Supreme Court held in *Amchem Products v. Windsor*,[78] that class members were deprived of adequate representation by class counsel in a mega-asbestos settlement because of intra-class conflicts of interest between currently injured class members and future claimants not yet identified. There had to be, said the Court, "structural assurance of fair and adequate representation for the diverse groups. . . affected."[79] Moreover, in another mega-asbestos settlement struck down by the U.S. Supreme Court, *Ortiz v. Fibreboard*,[80] the court held that class counsel's inventory settlement on different and more favorable terms than those provided in the proposed class action settlement for future claimants constituted a concurrent conflict of

---

77 Rule 2019(a) provides:

> (a) Data required. In a chapter 9 municipality or chapter 11 reorganization case, except with respect to a committee appointed pursuant to §1102 or 1114 of the Code, every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, shall file a verified statement setting forth (1) the name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition; (3) a recital of the pertinent facts and circumstances in connection with the employment of the entity. . . . The statement shall include a copy of the instrument, if any, whereby the entity, committee, or indenture trustee is empowered to act on behalf of creditors or equity security holders. A supplemental statement shall be filed promptly, setting forth any material changes in the facts contained in the statement filed pursuant to this subdivision.

Fed. R. Bankr. 2019(A).

78 521 U.S. 591 (1997).

79 521 U.S. at 594.

80 11 S.Ct. 2295 (1999).

interest. Applying these holdings to the bankruptcy context leads to the conclusion that because one subgroup's gains are at the expense of other subgroups, law firms may not simultaneously represent different subgroups in the same bankruptcy proceeding. That is, they cannot represent both malignant and nonmalignant claimants in the same bankruptcy proceeding because these subgroups are competing for a limited share of the same assets. In addition, they cannot represent both present claimant/creditors and future claimants who will seek compensation from the 524(g) trust. As stated in *Ortiz*, there has to be both structural protection of independent representation for subclasses with conflicting interests and also separate counsel to eliminate conflicting interests of counsel.[81]

Despite these conflicts of interest, these law firms nonetheless negotiate the "proper" allocation of limited funds among the conflicting inventory subgroups, unimpeded by actions of the bankruptcy court or of the U.S. Trustee. These conflicts of interest are compounded by the voting process that takes place to establish the 524(g) trust. The same relative handful of law firms that reached a conclusion as to how to allocate funds among the conflicting subgroups, thus denominating some of their clients as winners in the zero-sum game and others--who consequently received less--as losers, then go on to exercise the proxies they state that they have been granted to cast claimants' votes in favor of the plan, thus allowing the creation of the 524(g) trust. But these voting

[81] Ortiz, *id.*. *Cf.* Maryland Bar Ass'n Ethics Opinion 2003-10. The Opinion responds to the follow facts. Lawyer represents asbestos clients in suits against defendants A, B and C. A filed for bankruptcy under Chapter 11 and the creditors committee asked Lawyer to be the Futures Representative. To resolve any conflict, Lawyer announced that he would no longer represent clients suing A but would continue to represent his clients suing B and C. The Bar Ass'n opined that Lawyer's proposed action would not cure the conflict and would still violate Rule 1.7, stating: Lawyer's obligations to the futures "(to preserve as much of the 'pie' for these future claimants) will necessarily require [that lawyer] to advocate against [present claimants whom Lawyer still represented against other asbestos defendants] (who themselves want as large a piece of the 'pie' from [the debtor] as they may be able to obtain." Op. 2003-10, at 6-7.

rights which the law firms state have been delegated to them by their clients are fiduciary in nature, i.e., the firms have been entrusted with clients' rights which must be exercised in favor of each clients' fiducial rights. Moreover, under *Ortiz*, the law firms cannot represent conflicting interests. How then can they advise their multiple malignant, nonmalignant and unimpaired clients with conflicting interests, how to instruct their own counsel to vote to apportion the limited funds? The conflicts of interest and breaches of fiduciary obligation are further compounded by the fact that the attorneys claiming client proxies to vote on the 524(g) plan fail to disclose both to their clients, the tort claimants designated by the U.S. Trustee to sit on the ACCs, and to the U.S. Trustee, that they sit on multiple ACCs in other asbestos bankruptcies where there exists substantial contribution or indemnification claims against, or obligations to, the debtor's estate. These incestuous interlocking directorates would be illegal in other contexts and are especially corrosive in the asbestos bankruptcy context. A law firm which represents an ACC in a Chapter 11 case of one asbestos defendant would appear to have a diminished interest in having that debtor pursue contribution or indemnity claims against, or argue for the allocation of asbestos liability to, a second asbestos defendant in bankruptcy where that same lawyer also represents the ACC in that second bankruptcy where that firm's fee interest is enhanced more by the second bankruptcy than by the first.[82]

An additional conflict of interest exists in the case of the law firms that entered into the National Settlement Programs agreements (NSP) with Owens Corning setting forth specific amounts for various types of injury that Owens Corning would pay to

[82] These conflicts of interest are highlighted by a recent motion in the Owens Corning bankruptcy in which Owens Corning and Babcock & Wilcox propose, *inter alia*, to "wash" their contribution and indemnity claims. There are six overlapping ACC members in the two bankruptcies. In addition, the Analysis Research Planning Corp., a claims estimation expert frequently retained in asbestos bankruptcies and accommodative of plaintiff lawyers' interests, is the claims expert both for Owens Corning and for the Babcock & Wilcox FCR.

claimants. Under the terms of these agreements, most of the firms agreed to recommend to their clients that they agree to accept these specified amounts in settlement of their claims. Claimants who accepted the standing Owens Corning offer and signed releases accepted by Owens Corning thus entered into contracts with Owens Corning. Those contracting claimants who had not yet received the contractually specified amounts when Owens Corning filed for bankruptcy, had fixed liquidated claims against the debtor equivalent in most respects to the claims of commercial debt holders evidenced by debentures or notes. In fact, Owens Corning acknowledged that there were 61,000 such asbestos claimants.

After Owens Corning filed for bankruptcy in 2000, these same law firms also represent persons who rejected Owens Corning's offer as well as other asbestos claimants asserting "unliquidated and contingent tort claims." The conflicts of interest between the contract claimants and the contingent tort claimants is manifest. Contract claimants' interests are to minimize the value of the unliquidated claims in order to maximize their own pro rata recoveries. This would include demonstrating that the contingent tort claimants did not have valid claims under state law, that they had no actual injury or that exposure to Owens Corning products was not a substantial factor in causing any asbestos-related injury that they did have. At the same time, these law firms had a duty of loyalty to the contingent tort claimants to obtain the maximum recovery possible. Moreover, since the payments received by those who settled and signed the releases may be preferential and therefore avoidable, it is incumbent on plaintiff lawyers who not only represent these claimants but also those with liquidated and unliquidated claims against the debtor to so disclose this possibility. For example, clients represented by these lawyers who did not receive avoidable payments would potentially benefit from the recovery of the avoidable payments received by those who signed the releases. The conflict is further exacerbated when the attorney who represents clients who have received avoidable payments and who has himself received a percentage of these payments as fees -- itself a possibly preferential or otherwise avoidable payment -- is given a proxy to sit on an ACC on behalf of a client who did not receive such payments, without disclosing that conflict to the client or the fact that the attorney will seek to obtain a release of any avoidance claims against him -- contrary to the interests of the ACC appointees that the attorney represents.

I. Does The Appointment Of A Futures Representative Cure The Temporal Conflict?

I have already pointed out the inherent conflicts of interest that exist when a future claims representative is appointed by the parties in a pre-packaged bankruptcy.[83]

In a regular bankruptcy filing, Futures Claims Representatives ("FCR"), who negotiate a share of the assets to go into the trust on behalf of future claimants, are nominally selected by the debtor. In fact, plaintiff attorneys usually play a dominant role in that selection process. Appointments to the position of FCR are lucrative. Moreover, a number of FCRs serve in that capacity in multiple trusts.[84] Some FCRs openly vie for appointment as the FCR in other asbestos bankruptcies. To be so selected, however, they need the support of the entity which exercises the most influence on the selection process: the plaintiff attorney. It is no surprise, therefore, that FCRs rarely take positions

83 *See supra* section VI.D.2 (6).

84 *See, e.g.,* Testimony of Professor Eric D. Green, Senate Committee On The Judiciary, on S.1125, June 4, 2003 (indicating that Professor Green is the FCR in the Fuller-Austin, Federal-Mogul and Babcock & Wilcox bankruptcies.)

inconsistent with the interests of the plaintiff attorneys that control the bankruptcy process.

Because of the lucrative nature of the position, FCRs have a vital interest in the perpetuation of the status quo, especially in light of proposed legislation that would eliminate the asbestos bankruptcy trust, transferring all trusts' assets to a mechanism created by the legislation.[85] The effect of the self-interest of FCRs in the administration of asbestos bankruptcy trusts should be addressed in the course of the examination that I am advocating.

Finally, even though appointment of an FCR satisfies the §524(g) requirement and appears facially responsive to the holding in *Ortiz*, conflicts of interest nonetheless endure. For example, it is common in asbestos bankruptcies to divide future claimants into five to eight subgroups ranging from the unimpaireds to those with mesthelioma. Each subgroup has different applicable evidentiary requirements and different dollars amounts or ranges of dollar amounts. These dollar values which are listed in the TDP, or the Matrix that is part of the TDP, in effect represent allocations of the limited funds set aside for the future claimants among competing subgroups. It is doubtful that a single person, the Future Representative, can adequately represent the conflicting interests of each of the following subgroups: unimpaired asbestotic and pleural plaque claimants; impaired asbestotic claimants; asbestotic claimants with an ILO grade of 2/1 or higher; mesothelioma claimants; lung cancer claimants; and other future cancer claimants. To comply with the Supreme Court's holding in *Ortiz*, each subgroup of future claimants would have to have separate representation. As stated by the Second Circuit:

---

[85] For a brief description of the testimony of the designated FCR to represent FCR interests, purporting to support the idea of a legislative solution but recommending changes that would make any bill impassable, *see infra* note 111.

> Within the category of health claimants, marked differences exist between identifiable sub-groups that require division of health claimants themselves into appropriate subclasses.
>
> . . .
>
> [W]here differences among members of a class are such that subclasses must be established, we know of no authority that permits a court to approve a settlement without creating subclasses on the basis of consents by members of a unitary class, some of whom happen to be members of the distinct sub-groups. The class representatives may well have thought that the Settlement serves the aggregate interests of the entire class. *But the adversity among sub-groups requires that the member of each sub-group cannot be bound by a settlement except by consents given by those who understand that their role is to represent solely the members of their respective sub-groups.* [86]

The Second Circuit's analysis was substantially adopted by the Third Circuit in rejecting the *Amchem* asbestos settlement.[87] The Third Circuit ruled that certifying a unitary class of asbestos claimants, including present and future claimants with such conflicting interests, was improper because the conflicts "preclude[d] a finding of adequacy of representation. . . Absent structural protections to assure that differently situated plaintiffs negotiate for their own unique interests, the fact that plaintiffs of different types were among the named plaintiffs does not rectify the conflict."[88]

The Third Circuit's opinion which largely incorporated the Second Circuit's analysis, was adopted by the Supreme Court in rejecting the *Amchem* and *Ortiz* asbestos settlements. Both settlements had included claimants with widely conflicting interests in

---

86 In re Joint E. and S. Dist. Asbestos Litig., 982 F.2d 721, 741, 743 (2d Cir. 1992) (emphasis added); *modified on other grounds*, 993 F.2d 7 (2d Cir. 1993).

87 *See* Georgine v. Amchem Products, Inc. 83 F.3d 610, 631 (3d Cir. 1996), *aff'd sub nom.*, Amchem Products, Inc. v. Windsor, 521 U.S. 591 (1997).

88 *Id.* at 631.

a unitary class represented by a single representative or undifferentiated group of representatives; both lacked the structural assurance of fair and adequate representation of groups with conflicting interests.[89]

2. The Role Of Gilbert Heinz In Prepackaged Bankruptcies

Gilbert Heinz ("GH") is a law firm which devotes a significant part of its practice to representing asbestos tort claimants. The firm owns 70% of The Kenesis Group, which does claim processing for asbestos trusts.[90] GH has been retained by the defendant/debtor in a number of prepackaged asbestos bankruptcies, upon the suggestion of plaintiff law firms Weitz & Luxenberg and Motley Rice, to help facilitate the arrangement.[91] GH also represents or is co-counsel to asbestos claimants asserting claims against the companies that retained the firm to facilitate the pre-packaged bankruptcies. GH is thus representing conflicting interests in violation of Model Rule 1.7(a)(1).[92] Nonetheless, the bankruptcy court in the Congoleum bankruptcy granted the debtor's application to retain GH as its counsel, accepting GH's argument that the "current client"

89 *See* Amchem Products, Inc. v. Windsor, 521 U.S. 591, 627-28 (1997) (extensively quoting Second Circuit opinion and stating that "the settling parties, in sum, achieved a global compromise with no structural assurance of fair and adequate representation for the diverse groups and individuals affected. Although the named parties alleged a range of complaints, each served generally as representative for the whole, not for a separate constituency"); Ortiz v. Fibreboard Corp., 527 U.S. 815, 857-59 (1999) (a unitary class with widely conflicting interests among the subgroups precludes finding of adequacy of representation).

90 For a discussion of Kenesis, *see infra* nn.115 et seq.

91 The GH/Weitz/Rice team collaborated to arrange the pre-packaged bankruptcies of ACandS, JT Thorpe, Shoock & Fletcher and Congoleum.

92 ABA Model Rules of Professional Conduct, R. 1.7(a)(1).

prohibition in Rule 1.7(a)(1) is limited to adverse positions "in the same matter." Prevailing interpretations of this rule of ethics, however, are to the contrary.[93] Because of its numerous financial tier to major plaintiff asbestos firms, GH may also be violating Model Rule 1.7(a)(2), which prohibits a lawyer, absent informed consent, to represent a client if "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."[94] The bankruptcy court's decision in Congoleum is indicative of the lengths that bankruptcy courts will go to accommodate the interests of plaintiff lawyers in asbestos bankruptcies.

3. <u>The Role Of Joe Rice In The Combustion Engineering Bankruptcy</u>

Joe Rice, of the firm of Motley Rice, is one of the leading plaintiff asbestos lawyers in the country. He negotiated the terms of the Combustion Engineering pre-packaged bankruptcy agreement with ABB Ltd., the parent of Combustion. ABB agreed to pay Rice a "success fee" of $20,000,000 for obtaining the requisite 75% claimants' vote in favor of the Combustion Engineering ("CE") Master Settlement Agreement ("MSA").[95] While the bankruptcy court determined that this fee was not subject to the approval of the court, it held that it had equitable power to protect the process since Rice had "an actual conflict of interest in the case [because h]e is being paid $20 million by

---

93 *See* ABA Model Rule 1.7, cmt 6 (2004) ("absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated."); *see also*, Geoffrey Hazard and William Hodes, THE LAW OF LAWYERING, §1.7:203 (interpreting Rule 1.7(a) as prohibiting a lawyer's representation of adverse interests even where the matters are wholly unrelated).

94 ABA Model Rules of Prof. Conduct, Rule 1.7(a)(2) (2004).

95 *See* Alex Berenson, *A Cauldron Of Ethics And Asbestos*, N.Y. Times, March 12, 2003 at C1.

the parent of an entity he is suing. In addition, he has tort clients who have claims against Debtor. . . and he has contingency fee agreements with those clients who will be or have been paid through the CE Settlement Trust. . . and/or by the Asbestos PI Trust."[96] Under that equitable power, the court determined that Rice would have to return any amount of the fee paid and waive any unpaid amount unless he informed his clients of the existence and nature of the conflict and obtained written waivers from these clients.[97] Nonetheless, despite the conflict of interest and the requirements of the Bankruptcy Code, the bankruptcy court approved the plan.[98]

Apparently seeking to keep his "success fee" from being disclosed to his clients, Rice appealed. The district court vacated that portion of the bankruptcy court's confirmation order concerning the "Claimants' Representative's" success fee, concluding that the bankruptcy court lacked subject matter jurisdiction over the "Claimants' Representative's" "private, contractual relationship between himself and his *asbestos plaintiff clients*. . . ."[99] While it is true that Rice argued that he was acting only on behalf of his own clients and not on behalf of all asbestos claimants affected by the MSA, the Disclosure Statement refers to Rice as "Claimants' Representative."[100] Moreover, the

---

96 *In re* Combustion Eng'g, Inc. 295 B.R. 459, 478 (Bankr. D.Del. 2003).

97 *Id.* Despite finding a conflict and further finding considerable uncertainty as to just whom Rice was representing as well as misrepresentation by Rice of his role as "Claimants Representative," *id.* at 478, the bankruptcy court concluded that it could not compel repayment or waiver, *id.* at 479; it further held that "the prepetition vote was not tainted under the unusual circumstances of this case," *id.* at 47 and that "there was no prejudice created by the misrepresentation that Mr. Rice was Claimants' Representative." *Id.* at 479.

98 Since the plan was largely negotiated by a "Claimants' Representative" with an actual conflict of interest who was to receive improper payments from the debtor's parent, it is difficult to perceive how the court confirmed the plan in light of 11 U.S.C. §1129(a)(1)-(4).

99 *See* Opinion and Order, *In re* Combustion Eng'g, Inc. (D. Del. Sept. 15, 2003) (Bankr. No. 03-10495 (JKF), Dist. No. 03-755 (AMW) (emphasis added).

bankruptcy court held that Rice could not have been retained as a Claimants' Representative because he had a conflict of interest as to the estate due to his employment and payment by Debtor's parent which is a creditor of Debtor.[101] Furthermore, the "success fee" was not being paid by the claimants that he represented but by the parent of the debtor. If the district court's ruling is to the effect that the fee was, in actuality, a private contractual matter with his clients, then it effectively recognized that the $20,000,000 would have been available to have been added to the trust to pay claimants had it not been paid to Rice – making it all the more bizarre that the district court gave its effective imprimatur to the fee. The fee arrangement was also unethical in that Rice was being paid part of his fee by the adversary of his client (the parent of the debtor-to-be, which was providing most of the funding of the trust) without the express knowledge and informed consent of his clients.[102]

Time does not permit further elaboration of the amorphous if not troubling matter of just whom Rice represented in the CE bankruptcy. In a number of other bankruptcy proceedings, Rice has testified that though he and another attorney represented 75% of the asbestos claimants, he did not purport to "speak for" the claimants when he appeared before the court.[103] Moreover, despite repeated demands that he and other plaintiff counsel comply with Rule 2019[104] and list the names and addresses of their creditor/clients and the nature and amount of their claims, Rice and others have

100 295 B.R. at 478.

101 295 B.R. 478 citing to Fed. R. Bankr. P. 2014.

102 Model Rules of Professional Conduct, R. 1.8(f).

103 *See* Motion To Compel The Law Firm of Motley Rice LLC To Comply With Its Obligation Under Federal Rule of Bankruptcy Procedure 2019, July 6, 2004, *In re* Congoleum Corp. et al., Case No. 03-51524 (KCF) (Bankr. D. N.J.).

104 *See supra* note 77.

repeatedly failed to do so.[105] The purpose of Rule 2019 is to further the Bankruptcy Code's goal of complete disclosure and to ensure that lawyers adhere to ethical standards.[106] This includes disclosure of conflicts of interest so that bankruptcy courts can take prompt action to prevent such conflicts. The consistent failure by plaintiff attorneys to comply with Rule 2019 in asbestos bankruptcies facilitates the continuation of conflicts of interest in bankruptcy proceedings.

Finally, circumstances surrounding the district court's reversal of the bankruptcy court's requirement that Rice obtain the informed consent of his clients before he could receive the $20,000,000 "success fee" raise an appearance of impropriety that should be addressed both by appointment of a special examiner by the bankruptcy court or the U.S. Trustee to inquire into the matter as well as the commissioning of an investigation by this Committee. These circumstances also involve the roles of Professor Francis McGovern as Mediator and Advisor in the Owens Corning bankruptcy as well as other positions held by Professor McGovern.

U.S. District Court Judge Alfred Wolin appointed Professor McGovern and four others as Advisors in December 2001 to assist him in overseeing the bankruptcies of Owens Corning, W.R. Grace, USG, Federal Mogul and Armstrong World Industries. Because two of these Advisors, Judson Hamlin and David Gross, also served as class counsel for asbestos cases in the G-I Holdings bankruptcy and because legal rulings by Judge Wolin could serve as a precedent for the G-I Holdings bankruptcy in which these advisors had a financial interest, thereby giving rise to a conflict of interest, and further because of numerous *ex parte* meetings that Judge Wolin had with his Advisors and

---

105 *See* Motion To Compel, *id.*

106 *See In re* CF Holding Corp., 145 B.R. 124, 126-27 (Bankr. D. Conn. 1992.)

interested parties, the Third Circuit Court of Appeals issued a writ of mandamus to disqualify Judge Wolin from three of the bankruptcies. As members of this Committee are aware, this is an extraordinary remedy, only granted upon a finding of clear and indisputable evidence that a reasonable person, with knowledge of all the facts, would conclude that a judge's impartiality might reasonably be questioned.

Professor McGovern was later appointed as a Mediator in the Owens Corning bankruptcy. Professor McGovern had also served as a Trustee of both the Fibreboard Asbestos Compensation Trust (now the Fibreboard Settlement Trust) and the Celotex Asbestos Settlement Trust. Joe Rice and other plaintiff lawyers on the ACCs were responsible for Professor McGovern's appointments in those cases.[107] It appears that Professor McGovern may have continued to serve as Trustee of the Fibreboard Settlement Trust long after Owens Corning had acquired Fibreboard in 1997 and perhaps as late as 2001 when Judge Wolin appointed him as Advisor. It further appears that Professor McGovern's activities as Mediator included negotiation of a plan that transferred $140 million of Owens Corning's assets to the Fibreboard Settlement Trust – a development favorable to the interests of Rice and the other plaintiff attorneys.

While Professor McGovern was involved in his role as Mediator in the Owens Corning bankruptcy, he was employed by ABB, the parent of Combustion Engineering, to be a private mediator of Combustion Engineering's pre-packaged plan.[108] At the time he was hired by ABB, Rice was not involved in the deliberations. Rice was later engaged to put together a pre-packaged bankruptcy deal.[109] McGovern was present at a meeting

---

107 Deposition of Francis McGovern at 57, July 8, 2003, *In re* The Celotex Corporation.

108 *Id.* at 141.

109 *Id.* at 148-149.

in Zurich with ABB and Joe Rice when the offer of a \$20,000,000 "success fee" was made and accepted.[110] When asked whether he had contacted Rice as part of his mediation effort for ABB, whether he had traveled to Zurich with Rice, and whether he had discussed Rice's compensation with Rice, Professor McGovern refused to answer, claiming these facts were confidential.[111]

On September 10, 2003, after the bankruptcy court found Rice's unconsented \$20 million fee unethical because of an "actual conflict of interest" with his clients, and while the matter was on appeal to Judge Wolin, Rice participated in a six hour, *ex parte* meeting with Judge Wolin, Professor McGovern, Gross and other plaintiff counsel.[112] Little is known about the details of this meeting. Professor McGovern, when deposed less than four months later, said he did not remember what had occurred.[113]

---

110 *Id.* at 147-49.

111 *Id.* at 146-49. Professor McGovern has also played a role in coordinating the position of the FCRs with respect to S.1125, the Fairness in Asbestos Resolution Act of 2003, *see supra* note 84, though he was not an FCR in any of the asbestos bankruptcies. Professor McGovern's coordinating role is revealed in a communication from Professor Green to other FCRs that had apparently been meeting periodically to coordinate their position with respect to S.1125:

> Our beloved mentor and mediator Francis teaches on Mondays and therefore has kindly asked whether we can find another day for our next futures rep meeting. I am trying to schedule ASAP because of developments in many of the bankruptcies and the possibility that there could be some sudden and unpredictable activity on the legislation after Labor Day.

Email from Eric Green, Federal-Mogul Futures Representative, to other futures representatives, August 7, 2003. Since S.1125 would have dismantled the existing trusts and transferred its assets to the Act's funding mechanism, FCRs would have seen their position eliminated. Professor Eric Green, the FCR in three of the bankruptcies acknowledged so in his testimony before Congress expressing the view of the FCRs. *See* Testimony of Professor Green, *id.* While Professor Green expressed the FCRs support for "a national legislative resolution to the asbestos litigation crisis," *id.*, he advocated changes to the bill that would escalated the costs of the legislative resolution to levels unacceptable to the paying parties (defendants and insurers). At no point in his testimony did Professor Green acknowledge the specious nature of the overwhelming majority of present and future asbestos claims.

112 Time Entry of David R. Gross, September 10, 2003. Judge Wolin's log refers to this meeting as a session with "Francis and the boys" – the latter a term he used to refer to Rice and other leading plaintiffs' attorneys with whom the periodically met *ex parte*.

113 *See* Deposition of Francis McGovern, at 66.

Five days after this *ex parte* meeting, on September 15, 2003, Judge Wolin reversed the bankruptcy court's order regarding the $20,000,000 fee, relieving Rice of the obligation to notify his clients of the conflict of interest and obtain waivers or, in lieu thereof, disgorge his fee. Though Judge Wolin barred any inquiry into Professor McGovern's role in the Combustion Engineering case, there is evidence that Judge Wolin did in fact discuss the CE pre-packaged plan with Professor McGovern and his other Advisors both before and after CE filed for Chapter 11.[114]

The September 10, 2003 *ex parte* meeting was followed approximately two weeks later by another ruling by Judge Wolin staying a $2.4 million disgorgement order of Judge Newsome against the Kinesis Group, LLC ("Kenesis").[115] The Kenesis group is a claims processing firm 70% owned by Gilbert Heinz, the law firm hired by the debtor in the ACandS pre-packaged bankruptcy filing which works closely with plaintiff law firms involved in asbestos litigation and bankruptcies, including Motley Rice and Weitz & Luxenberg.[116] Kenesis was to be paid $3 million to do postpetition claims processing. Kenesis, in turn, subcontracted two thirds of that work to and paid approximately $2 million to another entity which was owned by a paralegal on leave from employment at Rice's law firm but using the firm as her address. Under this arrangement, it appears that the Rice firm's paralegal was determining the eligibility of claims submitted by Rice's law firm on behalf of its clients for payment from the ACandS settlement trust. This

---

114 *See* Motion of Kensington Int'l Ltd., et al. pursuant to 11 U.S.C. §§105 and 327 and Delaware Local Bankruptcy Rule 9019 For Order Disqualifying And Terminating Appointment of Francis E. McGovern As Mediator In These Chapter 11 Cases, at ¶ 34, May 24, 2004, *In re* Owens Corning, No. 00-03837 (JKF), (Bankr. D. Del.).

115 The following recitation of facts about Kenesis is taken from Memorandum of the United States Trustee In Support of Objection To Debtor's Application To Employ the Kenesis Group, Aug. 7, 2003, *In re* ACandS, Inc., No. 02-12687 (RJN) (Bankr. D. Del. 2003).

116 *See supra* section VI.E.2.

example of potential self-dealing apparently appears to merely scratch the surface of self-dealing in bankruptcy trust administration.

Given the circumstances described above with reference to Kenesis's subcontracting claims processing to a paralegal on leave from Rice's law firm, Judge Wolin's stay of Judge Newsome's order to disgorge the $2.4 million so far paid to Kenesis,[117] despite numerous violations of the Bankruptcy Code,[118] would appear to have been favorable to Rice.

The recounting of those events and circumstances raises at least an appearance of impropriety. Professor McGovern's statement to the press that during the course of performing his duties, he saw "bad things going on. . ."[119] amplifies this appearance. To protect the integrity of the bankruptcy process and to provide assurance to capital markets and to the public that asbestos bankruptcy proceedings have not been corrupted, the U.S. Trustee should be encouraged to appoint a special examiner to investigate these events and to depose all relevant parties. In addition, this Committee should exercise its oversight responsibility to assure that such an investigation is undertaken and carried out with appropriate vigor.

117 Findings of Fact, Opinion And Conclusions of Law Re: Debtor's Motion To Employ The Kenesis Group, LLC, Aug. 25, 2003, *In re* ACandS, Inc. Case No. 02-12687(RJN) (Bankr. D. Del.)

118 *See* Memorandum of the U.S. Trustee, *id.* at 6-13.

119 *Supra* note 5.

E. Issues In Bankruptcy Trust Administration

While I have pointed out a number of issues of concern with respect to administration of the bankruptcy trusts, including the issue of the lack of independence of the trustees – most of whom are hand picked by plaintiff lawyers[120] -- there is another matter of concern that I wish to bring to this Committee's attention.

As I have noted above, evidence of exposure in asbestos litigation is often questionable at best. However, that evidence is often weighty indeed when compared with the evidence of exposure required to be submitted to the §524(g) bankruptcy trusts to establish a claim.[121] In the course of my research, I have determined that exposure claims submitted on behalf of claimants to bankruptcy trusts may include conflicting assertions. That is, plaintiff lawyers may be asserting that a claimant had exposure to certain products at a certain work location for a certain time period when making a claim to trust A, and then for the same plaintiff, they are asserting an inconsistent work history and exposure statement to trust B, and so on.

Circumstantial evidence in support of this proposition exists in the form of "the path not taken." All asbestos bankruptcy trusts have as apart of the trust's plan, a trust distribution procedure ("TDP"). The TDP (and sometimes an accompanying matrix) sets forth the parameters for claiming against the trust, the evidence required for submission of a claim including the required medical and exposure evidence, the prescribed value of certain claims, and the percent of that value that the trust will pay. Since most claims submitted to one bankruptcy trust are submitted to other trusts as well, one would expect

120 While this is generally true, in a few instances such as the Manville Trust and in the Mid-Valley bankruptcy of the Halliburton subsidiaries, independent trustees have been selected.

121 *See e.g., supra* note 60 for a description of the exposure evidence required in the proposed Congoleum plan.

that as matter of efficiency, the bankruptcy trusts would establish a joint claims resolution facility to process claims for most of the trusts. The Eagle Picher and UNR trusts have done so but on a limited scale. The largest processing entity is the Claims Resolution Management Corporation ("CRMC"), a division of the Manville Personal Injury Settlement Trust, which processes the Manville Trust's claims. The CRMC actively bids for newly emerging trusts' claim processing.

The absence, to date, of such a central processing entity highlights a significant inefficiency in the operation of bankruptcy trusts. I offer two reasons that may account for the persistence of this inefficiency.

First, a joint processing facility would undoubtedly "computerize" the data submitted with claims. This would easily enable the facility to assemble the complete composite work history of each claimant by combining the exposure claims for each claimant from the claimant's submissions to each trust. For example, claimant A's submission to Trust JM might state, *inter alia*, that A worked at jobsite JM in June—November, 1960 and that is where he was exposed to JM's products. Claimant A's submission to Trust EP might state, *inter alia*, that he worked at jobsite EP from May -- October 1960 and that is where he was exposed to EP's products. The computer could easily be programmed to spit out such conflicting exposure claims. If plaintiff lawyers submit such conflicting exposure claims with some frequency, then a centralized processing facility would be unwelcome.

A second reason why trustees of the bankruptcy trusts may not have established an industry-wide joint claim processing facility is that claims processing is a lucrative business which presents substantial profit opportunities. On rare occasions, these profit opportunities become quite visible.[122]

If as I suggest this may be occurring, the corrobating evidence sits in the computer files of the asbestos trusts. But plaintiff lawyers control these trusts, having effectively selected the trustees and constituting the Trust Advisory Committees which have authority to oversee trustees' actions. No matter how inculpatory this evidence may be, it remains off limits to any form of public scrutiny, even as a matter of reality, scrutiny by bankruptcy courts or by the U.S. Trustee. Only a substantial investigatory effort by this Committee in the exercise of its oversight authority over operation of the bankruptcy laws, could succeed in shaking loose this data, which reposes in the computer files of the bankruptcy trusts.

VII. Conclusion

The asbestos bankruptcy practices I have described coupled with some of the implementations of bankruptcy law in the bankruptcy courts which cede near unbridled power to plaintiff lawyers, in my judgment, constitute a unprecented assault on the integrity of the bankruptcy process.

122 *See, e.g., In re* Nat'l Gypsum Co., 243 B.R. 676 (Bankr. N.D. Tex 1999) suggesting that the managing trustee of the NGC Settlement Trust resign as a condition for the trust to be allowed to purchase stock held by that trustee in a claims processing enterprise); Mem. of the United States Trustee In Support of Objection To Debtor's Application To Employ The Kenesis Group, In re ACandS, Inc. No. 02-12687 (RJN) (Bankr. D. Del 2003) (concluding that the debtor had retained a claims handling firm that was owned by the debtor's law firm to do postpetition claims processing which had subcontracted the work to an affiliate of a law firm represent claimants without disclosing these relationships or seeking bankruptcy court approval).

A necessary first step in restoring the integrity of the process is to identify and expose those practices and implementations that are having the most egregious effects. The Second Circuit Court of Appeals has noted that "the conduct of bankruptcy proceedings not only should be right but must seem right."[123] There is much going on here that at least does not "seem right" and raises compelling questions about the integrity of the bankruptcy process. This includes the circumstances surrounding the issuance of a rare writ of mandamus removing Judge Wolin as well as the other disquieting events that I have noted in this statement. It would appear, therefore, to be incumbent on the courts to undertake their own investigation of what is occurring by the appointment of special examiners to inquire into the process, take the testimony of some of the key players and report their findings.[124]

In addition to the creation of an appropriate mechanism by the courts to provide a full and detailed account of what has transpired during the course of Judge Wolin's administration of five asbestos bankruptcies, or failing such creation, then one to be undertaken under the auspices of the Judiciary Committee, I also urge the Committee to undertake a more pervasive study of the operation of the bankruptcy process in the context of asbestos bankruptcies.

---

[123] *In re* Haupt & Co., 36 F.2d 164, 168 (2nd Cir. 1966).

[124] Under the bankruptcy code, a debtor in possession has an obligation to act as a fiduciary for the entire estate. One of the remedies for breach of this duty is the appointment of a trustee or examiner. Bankruptcy Code §1104(c) provides that of the bankruptcy court does not appoint a trustee,

> then at any time before the confirmation if a plan, on request of a party in interest or the United States Trustee, and after notice and hearing, the court shall order the appointment of an examiner to conduct such an investigation of the Debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the Debtor or by current or former management of the Debtor, if—
> (1) Such appointment is in the interest of creditors. . . or
> (2) The Debtor's fixed, liquidated, unsecured debts, . . . exceed $5,000,000.

11 U.S.C. § 1104(c).

Finally, I recommend as an additional requisite step, amending §524(g) of the Bankruptcy Code to modify those perverse provisions that promote bogus claiming and repose near unbridled power in the hands of plaintiff lawyers. To that end, I urge this Committee to undertake the process of amending the Bankruptcy Code to restore both its balance and the integrity of the process.

Mr. CANNON. I would like Ms. DeAngelis and Mr. LoPucki, if you wouldn't mind responding to some of the things that Professor Brickman said. Is this a crisis or has he overstated? Do we have tools in place, Ms. DeAngelis, to control that, or is Mr. Brickman correct when he says 524(g) gives unbridled power to claimants' attorneys. You in particular, Ms. DeAngelis, you're speaking for the trustees, have you some control over this? Are your controls sufficient?

Mr. LoPucki, if would you give us your comments, your perspective, I would appreciate that as well.

Ms. DEANGELIS. Mr. Chairman, the provisions of 524(g) and their workings are reviewed by the United States Trustee as a plan provision, and we review it to assure that the provisions that are set out in the plan comply with the requirements of the Code.

As to how those provisions work after the plan has been confirmed, I cannot speak to that.

Mr. CANNON. Actually I'm asking another question here. I think what Mr. Brickman is saying is that the terms of 524(g) create a context for abuse. And what I am asking you, are you dealing with that abuse? I mean we're destroying—we destroyed 70 companies, according to Mr. LoPucki. Did you say that we have 70 companies in bankruptcy, plus some other bankruptcies of insurance companies, plus bankruptcies—and there are many of those; some of our leading companies of America are under terrific stress. When you think that Pfizer, a drug company, would have this problem, but in their history they owned a manufacturing facility that used asbestos.

What I need to understand from you—and I think that the whole panel will be interested—is do you think that either Mr. Brickman is overstating this, or that your tools are adequate to meet the concerns that he has raised?

Ms. DEANGELIS. I think many of the concerns that Mr. Brickman raised are problems that exist within mass tort litigation that are brought into bankruptcy and are not inherent or result from the 524(g) injunction. They're problems that exist within the tort system itself.

The statements that he makes with regard to the control by plaintiff's counsel, with respect to issues of conflict that they may have, with regard to the securing a number of plaintiffs to be represented by them, those are all issues that exist.

Mr. CANNON. What Mr. Brickman is saying, there is an advantage in bankruptcy court to have more complainants who comprise 75 percent of the number of people that are creditors, therefore there is an inducement. Does the Justice Department have tools to deal with that tendency toward abuse?

Ms. DEANGELIS. The Justice Department, Mr. Chairman, has tools provided by the Code, which is to examine the issues presented to look at 524 to assure that it is met. I would note one thing; Mr. Brickman makes—there's a point that's made about approval that's needed in order for a plan to be confirmed that is not unique to section 524(g). Approval is an inherent provision that is required within plan confirmations generally. In order to obtain confirmation of a plan, generally classes within the plan must accept it. And so that's not a unique provision to 524.

Mr. CANNON. Right. But I am trying to go someplace else. Mr. Brickman is saying, with great clarity, that there is abuse in this system. I am asking you if you have the tools to deal with that abuse, or do we need more tools or does that abuse not exist? I need to join that issue with what is happening in our bankruptcy courts. I know what the effect is on businesses that are being targeted. Is the court in the confines—we have torts. These things are going through the tort system. But increasingly we're moving into these complex bankruptcies based upon the future claims in asbestos. Is that court stuff? Are the rules that we're playing under sufficient to avoid the kind of abuse that Mr. Brickman has so eloquently expressed?

Ms. DEANGELIS. The provisions of the Code as we deal with them in day-to-day cases are adequate to meet the needs, I think, of the cases that come before the courts. The issues that are raised, the concerns that are raised by Mr. Brickman, I think are issues that all of us can continue to think about, and if there are views that the Justice Department has that could better inform Congress at such time we'd be happy to he present them. I'm not prepared today to present any.

Mr. CANNON. Thank you. We'll come back to this because my time has expired. But let me point out as we think about it—we're the deliberative body here—as we are thinking about it, companies are going bankrupt that are otherwise contributing dramatically to the success and benefit of our economy and country. So I want to come back to this.

Mr. LoPucki I'd ask you to follow up when I have time again. But now I yield 5 minutes to the gentleman from Virginia.

Mr. WATT. Thank you, Mr. Chairman. This is very disturbing testimony that we have heard from the last two witnesses at least. Reassuring testimony from the first witness. So I am trying to get to the bottom of a couple of things because I just want to be clear. The refilings—could I get maybe the one chart that was put up about refilings? I have it attached to my testimony, so I have the information or plan failures, plan failure within 5 years of confirmation. Let's look at that chart.

What I'd like to do is try to reconcile or merge the last two witnesses' testimony, Professor LoPucki and Professor Brickman, so that I am clear on whether the issues that we are dealing with, and perhaps even the purpose of this hearing, is an assault on asbestos litigation or whether we are talking about bankruptcies in general.

So the question I am asking, Mr. LoPucki, Professor LoPucki, is of the plan failures that are identified either from Delaware, New York, or all other courts, the 54 percent, the 31 percent in New York, the 14 percent from all other courts, how many of those were asbestos cases?

Mr. LOPUCKI. I am not certain, but I believe none of them were.

Mr. WATT. So the issue that you have put your finger on as a witness here today is really an unrelated issue to the issue that Professor Brickman has put his finger on; is that right?

Mr. LOPUCKI. I think there are two separate problems here.

Mr. WATT. All right. And your concern is about forum shopping and Mr. Brickman—Professor Brickman's concern is about the abuse of the bankruptcy court by asbestos litigants. Is that—would I be fair in characterizing it that way?

Mr. LoPucki. I would put it a little differently. I was not disturbed by the first 15 years of forum shopping. It was when the courts began to react to the forum shopping by changing what they were doing in order to attract cases. That's what I see as the problem here.

Mr. Watt. What benefit would there be to a court to attract a bankruptcy case?

Mr. LoPucki. This is $1 billion a year business.

Mr. Watt. Well, but the courts, the judges, are not in a profit-making posture, I hope. I would like to think that a bankruptcy litigant filing a case in Delaware, New York, or North Carolina would get the same result theoretically. I like to look at our justice system as being a justice system that delivers justice regardless of where the case is filed. So what would be the benefit to a judge or—I mean, I can understand the potential convenience of lawyers, convenience of litigants, might be factors; the lawyers and the experts are getting a lot of money out of this, but certainly no court ought to be doing stuff to attract cases. Or are they?

Mr. LoPucki. I agree that they should not be doing things to attract cases.

Mr. Watt. Why are they, if they are?

Mr. LoPucki. These are not article III judges. These are judges that serve 14-year terms. At the end of the 14 years they have to seek reappointment to the bench. The lawyers will be surveyed at that point about their competence. There are cities around the country where there are lots of corporate headquarters. The companies are filing bankruptcy, but they're all going out of town. Boston, for example, lost 20 of the 24 companies. Boston companies that file bankruptcy, those companies went somewhere else for their bankruptcy.

So the bankruptcy community in that city puts the pressure on to the judges, and the judges are from that community. These are their friends. These are the people who got them the judgeship in the first place. So they're sensitive to the needs of the people in their city.

Mr. Watt. Do you think that under that scenario, people, lawyers, would want to be filing in their home city, not someplace else? Am I missing something here? If I were trying to influence and get a hometown verdict, why would I, if I lived in Boston or North Carolina, move the case to Delaware?

Mr. LoPucki. If they go to Delaware or New York, they'll retain Delaware or New York counsel most likely. The local lawyers, the lawyer, say, from Boston will have little or no role in the case. There may not even be——

Mr. Watt. But that seems counterproductive. I thought it was human nature of most lawyers that I know to want to retain authority and control and influence in a case, not to defer it to somebody in another State.

Mr. LoPucki. The Boston lawyer would like to retain the case but the Boston lawyer can't, because they go to a New York lawyer or they go to a Delaware lawyer who will file the case in Delaware or New York.

Mr. CANNON. Would the gentleman yield? If you have got a large—if you're outside counsel to a large corporation and you have a deal with the corporation to try to get it to the next phase of its existence, and that means bringing in Delaware counsel, for instance, isn't this actually a way to enhance fees? Is that where we're headed; that you got lawyers working the system to increase their revenues over the long term or what—in other words, I agree with Mr. Watt that nobody is going to try and give up business, but if it's a deal where your fees continue to get paid because you're in a bankruptcy court that is sensitive to the interest of bankruptcy counsel, and as counsel you're probably going to be better off going to Delaware, is that where we're headed?

Mr. LOPUCKI. Think of it as two different bankruptcy bars. Say the lawyers in Boston and the lawyers in New York, they're both trying to get a particular case. So the executives in that company are going to seek advice. If they happen to seek, as a lot of them do, seek advice from New York counsel, they will probably end up in a New York bankruptcy. The Boston attorney won't have anything to say about that. Their own in-house counsel will want what the executives want, and what the executives want is very often at odds with what the company needs. That is to say, the company often gets sacrificed in this to the interest of specific individuals involved.

Mr. WATT. But if—aren't you just saying that the client in this case is the company who's looking for—looking to file bankruptcy? And isn't that always the case, that they're going to try to find counsel that will—I mean, the counsel is always going to be answerable; that happens in every case where you got a filing. They're going to start off being answerable to whoever retains them; isn't that right?

Mr. LOPUCKI. Yes.

Mr. WATT. And that changes in some way——

Mr. LOPUCKI. Well——

Mr. WATT.—in this process?

Mr. LOPUCKI. What's different here is that these companies have their choice of any court in the country. In most litigation you're very limited in the choices that you have. You select an attorney, there is some forum shopping going on in any kind—probably in almost any kind of litigation. But the forum shopping is more common in the bankruptcy litigation, and it's more dangerous because so many cases are moving that the courts are actually responding.

So that the executives will be told if you take this case to New York, you will not get a trustee appointed. If you file in your local bankruptcy court, you, the executive, may be out of office the day after you file. But if you go to one of these courts that is trying to get cases, they won't appoint a trustee in your case, because if they did, they wouldn't get the next case.

Mr. CANNON. The gentleman's time has expired. I would like to follow up on this point. What I think you're saying compared with some of the things you said earlier, is all about executives and control of the company and not about the benefit of the company.

Mr. LOPUCKI. I call these people the case placers. The attorneys are a major part of this, the bankruptcy lawyers, because the executives have to rely on them. The executives themselves, though, typically a CEO and maybe some other people in the company, usually control where the case goes and then post-petition lenders may be involved. But the creditors don't get any involvement. They don't get any choice. They're dragged along to the court that will be best for those people placing the case.

Mr. CANNON. So going back to what you said earlier about law firms competing for the bankruptcy business, what they're saying to the leadership of the company, hey babe, come here, we got the best deal for you.

Mr. LOPUCKI. Our court can do more for you.

Mr. CANNON. So if Boston is losing out, that's because—I take it where you're going is because the lawyers in Delaware are saying we got a better deal for you down here.

Mr. LOPUCKI. That's exactly right.

Mr. CANNON. That better deal is not for your creditors but for you the leadership of the company.

Mr. LOPUCKI. Yes. Precisely.

Mr. CANNON. Ms. DeAngelis, is this a problem that we need to deal with from your perspective? Because you got people flooding into your area because they get a better deal.

Ms. DEANGELIS. The issues that we look at with regard to retention of professionals is not why a company has chosen a particular law firm to represent it, but, rather, to look at the issue of whether the professional that is going to be—you know, that has been chosen by the company, whether it meets the test established.

Mr. CANNON. I understand you're looking at that rather—let me say this, but you have a case of a professional in the asbestos arena in particular—we have been looking generally—but in asbestos you have a guy who is sort of an old boy, at least as reported in the *Wall Street Journal*, who is making $100,000 a month compared to some relatively minor salary he was making as a professor of law. Isn't that the kind of thing that you need to look at in the big picture, to say my goodness, we have abuses going on here, we have enough money going to this professional—not in this case, but in aggregate—that we're getting distortion of the bankruptcy system.

Ms. DEANGELIS. I think we need to remember, though, that there is a distinction between those counsel over whom the bankruptcy court has jurisdiction to look at retention and fees and those that the court does not. The court does not look at the employment agreement, the terms of it, the scope of it, for individual attorneys who represent creditors. It only looks at the retention of sort of eligibility and compensation with respect to those professionals that are going to render service to the debtor, to the committees, to certain other constituencies, and will be paid from the estate.

Mr. CANNON. Maybe from multiple estates. But if you've got somebody who is working on these complex issues, making an extraordinary amount of money, as a professor may be making $100,000 or $200,00 a year, 10 or 12 times that on a monthly basis over a year, if a person is that distorted in his payment, is it possible, is there some way—are you looking at, are people in your situation looking at the effect of that kind of payment on the judgment of the person who's there when the old—the *Wall Street Journal* talked about was the old-boy system. So you got people winking and nodding, having ex parte communications with the judges, and bankruptcy is moving on all to the benefit of some people like the executives and to the detriment of the creditors. Is this not—are you familiar with that article in the Wall Street Journal?

Ms. DEANGELIS. I am. And what I would indicate is the attorneys that were the subject of that article, the old boys in a sense, they're counsel who represent individual claimants. They are not counsel.

Mr. CANNON. You had a consultant who is subject to your review, as I understand it, who is consulting the courts, he was a special counsel to the courts; and that should be under your jurisdiction, is it not?

Ms. DEANGELIS. If it is, if it is a professional who has been retained in the case—some of the asbestos cases were a little different. The issue with respect to the particular consultant was not that he was retained in the case, but that he was retained by the court as the court's adviser.

Mr. CANNON. Would you have any role in overseeing those kind of people who are retained by the court?

Ms. DEANGELIS. That's a very unique situation and they are not professionals who are being retained either under 327 or 1103 of the Code.

Mr. CANNON. So it is just the judge who is the person in a position to see that an adviser to his court gets paid.

Ms. DEANGELIS. And, again, I would suggest that is a very, very unusual, unique situation.

Mr. CANNON. I think Mr. Watt was making the point that this is not just about asbestos, but asbestos is the growing new complex bankruptcy prepackaged environment that we're going into. So that's—I'm actually quite concerned about where we're headed and about the uniqueness of bankruptcy if it means the system is not going to work.

Ms. DEANGELIS. I think the system does work with regard to those professionals over whom we have oversight. And with respect to them, we file the appropriate motions if we feel that the fees are unreasonable.

And I would bring to your attention a recent case which was a consultant whose retention was sought. And we were successful in disgorging $2 million with respect to those services.

So with respect to professionals over whom the court has oversight, we will continue to exercise our authority in looking at the terms of the retention, looking at the fees to try to determine the reasonableness of them; you know, recognizing that some of these large cases now require additional ways of dealing with what are very substantial fees.

Mr. CANNON. You said oversight of the people, the consultants that the court hires, but you mean that are still subject to your jurisdiction so the court can hire a special master of some sort that is beyond your control; and, as I understand it, the only control on those people is the judge and his judgment.

Ms. DEANGELIS. That's the case. And, again, that was the case in—with respect to some of the asbestos litigation.

Mr. CANNON. So I understand we're agreed that there is a huge problem out there when you get forum shopping and judges that have old-boy networks and get paid huge amounts of money to people who end up exercising a significant role in this process.

And maybe, Mr. LoPucki and Mr. Brickman, if I could have you respond to that concern and where we're headed. Obviously most folks, Mr. Brickman—on asbestos, I am deeply concerned about asbestos. And, Mr. LoPucki, you're looking at asbestos. I think you said those are the next big cases. Can you give us feedback on what we need to be worried about there?

Mr. LOPUCKI. With respect to the asbestos cases, we're very specialized in academia. I am studying cases that are $220 million and over. I have all of those cases in any database. That includes about 8 or 10 asbestos cases. The asbestos companies generally are in good financial condition other than the fact that they have the asbestos liability hanging over them. That's the reason that they don't show up in the 5 years after emergence in those refilings. Within 5 years after emergence, you see none of these asbestos companies.

And there was another study done by another academic that came to this same conclusion, I think more generally, that the asbestos companies are typically companies that are strong except for their asbestos problem.

Mr. BRICKMAN. Mr. Chairman, in my written statement I detailed numerous instances of abuses and conflicts of interest over which the U.S. Trustee does have jurisdiction. And with very rare exception, the U.S. Trustee does not exercise that jurisdiction to deal with conflicts of interest that are absolutely pervasive.

For example, there are in effect interlocking directorates running all of the asbestos bankruptcies. These are the Asbestos Claimants Committee. The U.S. Trustee appoints claimants to the claimants committee who immediately resign in favor of their lawyers. These lawyers serve on multiple ACCs, Asbestos Claimants Committees, so that they're controlling multiple asbestos bankruptcies; they are rife with conflicts of interest, because a number of these debtors have potential claims against other debtors, claims for contribution. These are some complex issues.

Nonetheless, what I can say, with great certainty, is that the office of U.S. Trustee here has not done the job that has been accorded to it by the statutes, by the Congress.

And you need look no further than what goes on with the office—with the asbestos claimants committee, which is that basically, once the U.S. Trustee appoints the claimants, it steps away and does not see, does not want to see, perhaps what results thereafter, which is that the plaintiff lawyers then step in. They have the proxies. You have plaintiffs lawyers that have conflicting interests. Some represent mesothelioma cases, some represent unimpaired cases. These conflicts of interest are endemic. They pervade the entire asbestos bankruptcy process.

Mr. CANNON. Mr. Brickman, you have written a lot of material. If you'd make that available to us, we'd like to make that part of the record.

Mr. BRICKMAN. I will.

Mr. CANNON. Thank you. We both have gone over a little bit and if I can ask one more question. That was a pretty direct statement. Would you like to respond to that?

Ms. DeANGELIS. I would. The formation of creditors' committees in asbestos cases follows the same procedure that we utilize in all cases, which is for us to form a representative committee of the types of claims that are—that fall within that particular class. With respect to asbestos claimants, we will form a committee that's made up of the asbestos claimant, not attorneys.

And we will put on that committee claimants who have representative interests, those who have what some refer to as minimal impairment, you know, through those who are representatives of estates for claimants who have died as a result of their asbestos injury. Once that committee is formed, it has authority to act and to enact its own bylaws. And if in its process it allows and authorizes counsel to appear on its behalf, that is an appropriate exercise of its corporate authority. We will become involved when there are allegations of mismanagement and fraud or allegations that the individual member is not meeting the fiduciary duty and we will remove members from committees in those instances.

Mr. CANNON. And that would mean removing the lawyer.

Ms. DeANGELIS. No, it would be removing the member. If, in fact, a member has resigned, then that information we clearly would want to know because then there would be no basis upon which an attorney sits, but if the attorney is sitting pursuant to appropriate bylaws that have been enacted or appropriate resolutions of the members, then we do not get, you know, we don't sort of impose ourselves within that process.

Mr. CANNON. Mr. Brickman, you seemed intent on responding to that.

Mr. BRICKMAN. The appointment of the claimants to the asbestos creditors' committees to represent the diverse interests is immediately superseded. The reality of asbestos litigation and bankruptcy is that these are immediately superseded by the plaintiff attorneys who control the show. The U.S. trustee is saying, well, we don't—that's not our purview. We don't pay any attention to the reality of the process. We look only at the formality of the process. But the reality of the process is that there are conflicts of interest on the part of the people who run the asbestos claimants committees. And as I said earlier, interlocking directorates, which compound those conflicts of interest in incestuous ways.

Mr. CANNON. And which, outside of the bankruptcy context, have resulted in many and apparently many, many more bankruptcies of companies caught in the problem. Mr. LoPucki has talked about where you have complex issues of whose interest is at stake, whose going to represent that interest, and where that counsel will come from. My time—we actually have gone way over time on both sides. I'll yield back and recognize the Ranking Member for 5 minutes.

Mr. WATT. Thank you, Mr. Chairman. I obviously didn't walk into this hearing with any preconceived notions about where it would come out, but it seems to me that we probably ought to make sure that we don't leave some wrong impressions, which was why I wanted to be sure that the problem that Professor LoPucki identified and the problem that Mr. Brickman identified really are two separate problems. Both of you all agree.

Mr. BRICKMAN. Yes.

Mr. WATT. Okay. Mr. LoPucki, Professor LoPucki, apparently is concerned that creditors don't have enough input into the process once the bankruptcy is filed. Professor Brickman seems to be saying that the creditors in asbestos cases, if they were to exercise the authority that they had appropriately, might have too much authority in the process. It's the asbestos claimants that are the creditors in those cases. So I want to make sure that nobody goes out of here thinking that these two things come together to form one great big problem. That's what I want to be clear on, because asbestos cases have enough issues independent of getting them tied up into all the problems with bankruptcy for us to then give—pile on to them in another way to say that they are creating the bankruptcy problems that professor LoPucki has identified. They are not doing that, and I want to be clear on that. If we can be clear on it, I am going to give Professor Brickman a chance to clarify it for us if—not to express concerns about asbestos litigation in general, but to make sure that these are two separate problems. Professor Brickman, you're familiar with a study done by Professor George Benston.

Mr. BRICKMAN. No, I'm not.

Mr. WATT. Okay. All right. In that study, which I ask unanimous consent that we be allowed to submit for the record.

Mr. CANNON. Without objection so ordered.

Mr. WATT. And I'm not defending the results of this study. I want to be clear on that because I don't have any idea whether his study is better than yours or is different than yours or even covers the same territory. But as relates to the problem that has been identified by Professor LoPucki, he makes it absolutely clear, if his study is correct, that those problems are not asbestos bankruptcy problems, they are—because it is a different—there are five or six points that he concludes in his executive summary.

First, each of the seven companies studies, and he lists them here, they will be part of the record. Remain profitable after the bankruptcy was over. Number two, changes in the Chapter 11 companies total assets showed that they continued to be viable ongoing enterprises after the bankruptcy. Number three, that total employment at these companies increased or did not materially decline after the bankruptcy.

Number four, that all the companies met their obligations to fund employee pensions after the bankruptcy. And Number five, or six or whatever the appropriate next number is, these companies should do well in the future. And he's identified these companies. So these are not repeat failure companies like the ones that have been identified by Professor LoPucki. Is that right? Are we together on that?

Mr. LOPUCKI. I agree entirely.

Mr. WATT. Okay. All right. Now, the question I have—are you in agreement with that Professor Brickman, before I——

Mr. BRICKMAN. Is the study you're referring to a study of asbestos bankruptcies?

Mr. WATT. Yes.

Mr. BRICKMAN. Okay. I am familiar with that study. I didn't know it by title.

Mr. WATT. And the companies are Babcock and Wilcox, Owens Corning, Armstrong World Industries, Building Materials Corporation of America, W.R. Grace and Company, U.S. Gypsum Corporation, Federal Mogul Corporation, all of them have filed bankruptcy, and his study of those seven companies reached the conclusions that—now, I'm not verifying the accuracy of the study, but I'm saying that if you look at the criteria that have been applied by Professor LoPucki, those companies don't fit that criteria as the problems—as being the problems that Professor LoPucki has identified.

Now, that's not to say that there are not other problems. But I'm wondering whether the concerns you're having have more to do with—have less to do with bankruptcy and more to do with your concerns about the way asbestos litigation is proceeding.

Mr. BRICKMAN. I understand.

Mr. WATT. Do they or do they not?

Mr. BRICKMAN. They do not. Asbestos bankruptcy is simply a continuation of asbestos litigation in another forum. And the problems that I pointed out in my written statement are problems in the bankruptcy process. To be sure, they're an outgrowth from problems in the litigation and the tort system, but the problems I point out are problems in bankruptcy. In the article that I'm going to make part of the record, I go into asbestos litigation in the tort system.

But in my written statement I look at the bankruptcy process. In addition, with regard to the study that you cite, it is contradicted by a study done by a Nobel Prize winning economist coupled with another study that indicates that approximately 500,000 jobs were either lost or not created as a consequence of asbestos litigation.

Mr. WATT. Well, let's make sure we get that one in the record too, for the purpose of—those two studies in the record. I mean I'm not trying to bias this one way or another. I started with my opening statement saying I didn't know what the problems were in this area, and/or what the real result of this hearing would be. So I don't have a dog in the outcome of this fight. I just want to make sure that the record is full and complete so that if we start trying to argue toward some particular result at the end of this hearing, we'll have the full range of information to make an intelligent set of judgements from it.

Mr. Brickman, can you make those two studies available to us for inclusion in the record.

And I'm happy to yield back Mr. Chairman. I know I am well over my time.

Mr. BRICKMAN. Yes, I can. I cited to them in my law review article and be happy to make them available.

Mr. CANNON. Did you want to make any additional comment on the subject?

Mr. BRICKMAN. I just will give you the two studies, one is done by the Rand Institute and the other is a study by Joseph Stiglitz and the company that he runs titled "The Impact of Asbestos Liabilities on Workers in Bankrupt Firms." [1]

[1] The RAND Institute study entitled "Asbestos Litigation Costs and Compensation: An Interim Report," is not reprinted in this hearing but is available on-line at *www.rand.org/publications/*

Mr. CANNON. Thank you.

Mr. BRICKMAN. I'll make those available.

Mr. CANNON. Let me just, that in my mind there's a clear distinction between problems in bankruptcy and problems that are unique to asbestos. My concern and part of the reason for this hearing is that the new cases we're going to be seeing in bankruptcy, the new complex cases are these pre-packaged asbestos cases.

So my concern here and where I would like to go in the next couple of minutes is to get a sense of how the playing field is going to work as we move into these increasingly complex but narrowly issued bankruptcy cases, where I think you said, Mr. LoPucki, you've got healthy companies except for the asbestos and so their failure rate—there are many differences that exist between large bankruptcies and asbestos bankruptcies. They are huge. A large company with a complex bankruptcy, where the company's failing and is not healthy is I think substantially different from where you have the healthy company that has an asbestos problem that is going to suck resources out of it, reduce jobs available in America, and that's where I'm concerned about the playing field, and in particular, the trustees and the trustees' role.

And Mr. Brickman, maybe if I can come back to you. Or actually, Mr. LoPucki. We're talking about the difference between these kinds of healthy companies that have asbestos and others. As you look at the future and see the kinds of distortions that you have testified about, relating to the motivations for companies to go to certain jurisdictions, the motivations for certain jurisdictions to try and attract this large legislation, how does that affect asbestos companies in particular in the future.

Mr. LOPUCKI. Most of these major asbestos companies have chosen the Delaware bankruptcy court. The question I have that I cannot answer, but I think it's important here, is the question whether the plaintiffs have figured out a way to participate in court selection. Because if they have not, then it will be the interests of others who will be served, because the cases will go to the courts that serve those others. Whoever's picking the court, that's whose going to win in this system. So the issue here, to my mind, is do the plaintiffs, do they have a way that they can get some leverage on the company to pick the court, which I'm doubting it, but I'm just not—I just don't have the information necessary to know.

Mr. BRICKMAN. Can I supplement that? In pre-packaged bankruptcies the plaintiff lawyers do have that control over picking the court.

Mr. CANNON. You're right. Because when you say "plaintiffs," you're talking about the plaintiffs in the litigation system, not the plaintiffs in bankruptcy. So to be clear, you're saying that when you get a pre-packaged bankruptcy, that's because the tort lawyers are talking to the stakeholders, some of the stakeholders in the corporation. They're talking to the stakeholders and they have the choice about where to go and who are those stakeholders? The executives——

DB/DB397/DB397.pdf. The study entitled "The Impact of Asbestos Liabilities on Workers in Bankrupt Firms" is reprinted in the Appendix.

Mr. WATT. If the gentleman will yield, that seems to me to be a big jump. It might be true, but it seems to me to be a big jump.

Mr. CANNON. Well, I think the reason we are taking that jump is because Mr. LoPucki said much earlier that the number of CEOs who are retained has skyrocketed. Is that not correct?

Mr. LOPUCKI. They are more likely to be retained in office now. Much more like the than they were in the 1980's.

Mr. CANNON. And I suspect that has a lot to do with where they choose to go to bankruptcy and how they negotiate with the plaintiffs bar to get them to a court where they are going to be——

Mr. WATT. Well, if the gentleman would yield, as I understand it, in asbestos litigation, that's not even an issue because you're not trying to chase the CEO out. So that's not a criteria. You're trying to retain the CEO because—and the objective, remember, of Chapter 11 in general is to come out the other side of the bankruptcy with a vibrant company that continues to hire people, that we don't lose a business. That was the whole—that's the whole purpose.

Mr. CANNON. Reclaiming my time. I can't believe that we are at odds on this particular issue because the guys who get screwed when the CEO stays in office and gets bonuses, are the people who work on an hourly rate.

Mr. WATT. No.

Mr. CANNON. Or lose their jobs. Because a piece of the business disappears.

Mr. WATT. What I'm doing is differentiating this issue so that it doesn't make it sound like this is all about asbestos cases. That is not the objective in these asbestos cases because what you're trying to do in the asbestos cases is to—and Professor Brickman indicated, yes, they are trying to make the company stronger.

Mr. CANNON. Reclaiming my time. We agree, and I think we understand each other and the distinction between asbestos and nonasbesots is well taken because these are healthy companies as they come out. But my point and what I'd like to get some feedback from everyone on the panel is this question. Are we—are the interests of certain players like the executive team, and the plaintiffs coming into alignment at the cost of society, at the cost of the hourly worker, at the cost of the security of his job or even the possibility of a job?

Are we getting—as we move in from this complex litigation that has changed because of this complex bankruptcy litigation which has changed because we have had courts trying to attract business and trustees apparently trying to attract business, and a system trying to attract business, in the process, are we getting a distortion which means that CEOs and their executive team and their in-house lawyers, and the lawyers that are trying to attract business to their areas are working with, in particular, in the asbestos cases the plaintiff's bar to come through a system which minimizes the pain for the executives and optimizes their benefit? And that's, I think, the question and indicates the overlap between these two issues. Mr. LoPucki.

Mr. LOPUCKI. If you have a pre-packaged asbestos case, I take that to mean that the plaintiffs attorneys have made an agreement with the company as to how they are going to settle the matter. They have not filed the bankruptcy yet, but they have made their deal. In that situation, historically what's happened is that the companies will go to a court like the Delaware court that will not inquire into the deal, but will simply approve the deal. They will rubber stamp the deal so you lose all of the bankruptcy protections for various parties in that case. Everything—the court will treat it as a 30-day pre-pack. They'll file the case. Thirty days later they'll have a hearing and it's all over with. Nobody to represent anyone in the case.

Mr. CANNON. And these courts can handle a lot of pre-packaged cases and the local bar gets the huge benefit of having a much better, much more attractive environment for the people making decisions in the corporations. Am I getting the point here?

Mr. LOPUCKI. Yes, you are.

Mr. CANNON. Mr. Brickman do you want to add to that? Because what I am seeing here, and this stinks. This really, really stinks.

Mr. BRICKMAN. What Professor LoPucki said hit the nail right on the head. That is exactly what happens. There's been only—in only one instance has a bankruptcy judge refused to approve the pre-packaged plan, and though it was a Delaware bankruptcy, he's a California bankruptcy judge who was, I guess, visiting in Delaware. But in all other cases, the bankruptcy judges just hold their noses and approve the plan. That's the plan with the $20 million bonus payment to Joe Rice. This is the plan—well, we haven't seen the approval yet, but in the Owens Corning bankruptcy, the first plan that the debtor brought forward aroused the wrath of the plaintiff lawyers. They came back with a second plan, which was far more accommodative to their interests at the expense of the commercial creditors.

But in that second plan there was $70 million set aside for the corporate executives, which I did not see in the first plan, though I can't say with certainty that it didn't exist. It simply wasn't in the first plan. So that there is a coincidence of interest generated between the plaintiff lawyers and the CEOs and corporate officers; and the people that lose are the shareholders, the people that lose are the people with serious injuries because the plaintiff lawyers largely represent the persons without any injury, the claimants without any injury cognizable by medical science.

The mesotheliomas, the cancers, those claimants get short shrift in this process. The futures representative is selected by the company and the plaintiff lawyers, and they control the actions of that person. They pay his salary. It's laughable to suppose that that person is going to protect the interests of future claimants in that pre-packaged bankruptcy plan because he is under the direct control of the plaintiff lawyers and the company who are negotiating in their mutual interest.

Moreover, as these bankruptcies develop, especially the pre-packaged bankruptcies, they generate more power for the plaintiff lawyers in the pre-bankruptcy stage. That is to say, the ability of the plaintiff lawyers to control the bankruptcy process gives them leverage in what I'll call the pre-bankruptcy process to go to a CEO and demand that he agree to settle cases in the tort system because he understands the power that they exercise within the bankruptcy process. That accrues under the bankruptcy process because the plaintiff lawyers will end up controlling a majority of the stock of the reorganized company.

So the CEO knows that if they want to be a participant in that new company, he has to follow the wishes of plaintiff lawyers because they will be his bosses. It is rife with conflicts of interest throughout the entire process and I do hope this Committee does take additional steps of an oversight nature to spread this on the record.

Mr. CANNON. I take it, Ms. DeAngelis, that as long as these things are all done by the rules, you don't—your division doesn't have much to do with the fraud or other problems that might occur here that seriously and substantially distort our system.

Ms. DEANGELIS. They are provisions within the Bankruptcy Code that set out the requirements for confirmation of a pre-packaged bankruptcy case. That's our job to review the plans that have been filed, to monitor the process, and to comment when the procedures or the provisions are not appropriate, to bring those matters to the attention of the court.

Mr. CANNON. If you've got, I think Mr. Brickman talked about people using a script from their lawyer. They're suggesting that they're not telling the truth when they give testimony, or people who go to doctors who don't—who produce evidence that may not objectively otherwise exist, do you have the power to deal with those kinds of abuses.

Ms. DEANGELIS. Those are generally issues with regard to validity of claims. With respect to validity of claims, very seldom will the United States trustee get involved in what is clearly a two-party dispute where parties are represented by counsel. We do not look at the validity of claims, unless there are allegations of fraud or misconduct or criminal conduct, in which case we would refer it to the U.S. attorney.

Mr. CANNON. For criminal action.

Ms. DEANGELIS. That's right.

Mr. CANNON. So if you sense there's some problem out there you're going to call on the prosecutors.

Ms. DEANGELIS. That's right. If there is information presented to us that—that's credible, we will refer to.

Mr. CANNON. Let me just make a distinction for the record and you can correct me if I'm wrong. You refer to this as two-party actions with lawyers, with counsel. But what we are dealing with here are complex parties that have many, many people, and I think what Mr. Brickman is saying is that there are inherent conflicts between and among them and certainly between parties within and parties without that litigation. So my sense is that while you want to see the rules played by, we've got a group of people that have figured out, that is, the bankruptcy bar, including the plaintiffs and the defense and plaintiffs lawyers in asbestos cases and executives as we move out in the circle here, that are playing a game by your rules but coming up with outcomes that are highly distortive of our economic system. But you're going to play the referee in a relatively small area of that larger conflict and you think you have enough authority to do that.

Ms. DEANGELIS. We enforce the Bankruptcy Code as it is written. And I, again, want to reiterate that the conflicts that exist with regard to the asbestos plaintiffs bar are conflicts that are inherent in the mass tort system and they come into bankruptcy just by virtue of the bankruptcy having been filed. They are not the type of representations—because they are representations of individual claims, of claimant, they are not the representations over which either the bankruptcy court has authority, over—or over which we exercise oversight.

Mr. CANNON. Thank you. Because that's, I think, exactly the point that I have been trying to get to for much of this discussion. The fact is you've got some people in America, some groups of people who figured out how to get out from under—how to solve their problems in ways that are inherently full of conflicts and inherently enormously important for the American economy. I think Mr. Watt had a question. I yield the time to him for that.

Mr. WATT. I just wanted to say that I think it's unfair for us to ask Ms. DeAngelis to defend the whole integrity of the bankruptcy system. I mean, she didn't come here to do that. If it's—if there are shortcomings in that system, as she said, her job is to enforce the Bankruptcy Code. And if the code itself is inadequate, it's because we wrote it inadequate. Now, there might be problems—and we ought to put our fingers on that.

Mr. CANNON. Will the gentleman yield? May I just point out that I don't mean to put on you the spot on this, Ms. DeAngelis. I think you answered the questions marvelously. You have performed very well here. But I think inherently what we have is we are asking the trustees to do things they can't do, and we need that clear so we can say what do we need to do here because we've got a system that doesn't have anything to do with trustees but is destroying our manufacturing base in America. And I think that's vitally important.

So I hope that this is not taken personally. I think you've done a marvelous job answering questions, and especially the last answer was very clear.

Mr. WATT. But I hope the Chair is also aware that that exists in a number of instances. It's not only in the bankruptcy system. It's not only in the tort litigation system. There are a number of instances where people are scratching each others' back, you know. There are mergers taking place constantly, where there are golden parachutes. I mean, you know, so this is not unique to just this area. And I'm not defending it in this area. But the question I wanted to get to, though, it seems to me that if anybody is not protecting the integrity of the system it's not Ms. DeAngelis' office. It might be the judge's. And so that leads us to the question of whether going to longer tenured judgeships—this whole thing of judges competing for cases is troubling, more troubling, is as troubling to me as some of the other allegations because I never thought a judge—none of the judges I ever went in front of competed for cases. They were trying to get rid of them so that they had less and less to do. I hear a different scenario here. Competition for cases that may be aimed at getting tenures extended at the end of the 7-year term or whatever the term is.

Mr. LOPUCKI. Fourteen years.

Mr. WATT. Fourteen year term. Is a solution that you're suggesting or one of the solutions that you might be suggesting going to some different kind of an appointment system or a life-time tenure where they wouldn't have to compete or what would your suggestions about how to solve that be.

Mr. LOPUCKI. Life-time tenure would probably be a positive change. But at this stage of this competition, I think it's too late for that to solve the problem. We have the court in Delaware, which has created a large industry, many people have moved to Delaware in reliance upon this industry being there. Congress is about to give Delaware four more judges, it appears. You've got a very large thing that is in place there now and won't stop just because——

Mr. WATT. Maybe we should not just give them the judges and then they will be so overburdened that they can't frustrate the system like you're saying they're frustrated or are frustrated in another way.

Mr. LOPUCKI. That might be an effective approach to it. I would think that the judges in Delaware right now are working extremely hard, very long hours.

Mr. WATT. But they're still competing for cases is what I hear you say.

Mr. LOPUCKI. They are. Less intensively now because they're awaiting these new judges that they're scheduled to receive and that they think they will receive. If they get the judges then those judges will be there and those judges will need to have cases. And even if they are article three judges, at that point in time, what can you do, if you're a bankruptcy judge in Delaware, where there are no cases unless you attract those cases.

Mr. WATT. I yield back.

Mr. CANNON. Mr. LoPucki, are you aware as to whether or not bankruptcy judges get retirement when they finish their 14-year term? In the claims court, a judge who finishes his or her tenure term then gets the same payment for life. It's a retirement. And the theory there is that you're not causing judges to try and get reappointed. In the case of the claims court, the biggest party is the Federal Government, and it would be unseemly to have a claims court judge against a—need to go to the Government to get reappointed. In that case, do you know, if——

Mr. LOPUCKI. No, I don't know how their retirement system works.

Mr. CANNON. We will check that. I want to thank the panel. I think this has been very, very instructive. The information has been very good. And I hope that we will take a deeper look at this. Maybe focusing on a—given the transition that we have here, between complex cases that are now moving into pre-packaged asbestos cases and the conflicts that are obvious and we appreciate your particular comments Mr. Brickman in that regard about the inherent conflicts. We may want to just take this up again and look more closely at it. So I want to thank you for your being here. And we are adjourned.

[Whereupon, at 4:35 p.m., the Subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

STUDY ENTITLED, "FINANCIAL ANALYSIS OF ASBESTOS COMPANIES UNDER CHAPTER 11 REORGANIZATION," SUBMITTED BY MR. WATT

Financial Analysis of Companies That Filed for Chapter 11 Bankruptcy in 2000 and 2001 as a Result of Asbestos Obligations

Prepared by
Professor George J. Benston
October 30, 2003

Financial Analysis of Asbestos Companies Under Chapter 11 Reorganization

Hundreds of thousands of people have become ill or died because they were exposed to processes or products that used or contained asbestos. The health and financial consequences to these victims and their families have been devastating. Compensation from asbestos companies or their predecessors is their legal right.

Those responsible for their devastating condition are obligated to help them and their families cope with the daily struggle of asbestos disease, as they try to restore their lives. Seven of the largest companies that were facing huge asbestos liabilities because they or their predecessors had exposed their workers to asbestos sought Chapter 11 bankruptcy reorganization protection in 2000 and 2001. This protection allowed them to remain in business, while, at the same time, meeting their legal obligations to their former employees and their families.

The Association of Trial Lawyers of America sponsored the following study to examine the financial condition of the seven largest asbestos companies before and after they sought Chapter 11 protection.

Emory University's John H. Harland Professor of Finance, Accounting, and Economics George J. Benston analyzed these companies and compared them to companies in their industries that did not declare bankruptcy to determine how successful their operations were under the supervision of the Bankruptcy Court, such that they would be able to honor their obligations to asbestos victims and continue to provide products and services to their customers and jobs for their employees.

The views and opinions expressed in this study are solely those of Professor Benston and do not necessarily reflect the views and opinions of the Association of Trial Lawyers of America.

Executive Summary

The seven "Chapter 11" companies and the dates on which they filed for bankruptcy are:

COMPANY NAME	DATE OF FILING
Babcock & Wilcox Company	February 22, 2000
Owens Corning	October 5, 2000
Armstrong World Industries	December 6, 2000
Building Materials Corporation of America (BMCA)[1]	January 5, 2001
W.R. Grace & Co.	April 2, 2001
US Gypsum Corporation	June 25, 2001
Federal-Mogul Corporation	October 1, 2001

Summary of Findings

Professor Benston notes that companies that file for Chapter 11 reorganization are faced with especially high legal costs and other costs related to bankruptcy reorganization. They also must contend with court-imposed restraints on their operations and holdings of liquid assets to pay claimants, which reduce profitability.

Nevertheless, based on his analysis of the seven companies' financial statements over the five years 1998–2002 and projections over 2003–2005, he concludes: "On the whole, they essentially have increased or stabilized their sales, assets, employment, and profitability, and have projected increases. It is fair to say that they are viable and likely to be increasingly successful companies that should generate funds to exit bankruptcy significantly stronger than when they went in."

- **Each of the 7 companies studied remained profitable after bankruptcy.**
  They have been able to continue their operations successfully, and with few exceptions, they have prospered, increasing their sales. They have been able to maintain their assets and employment, meet their obligations to business creditors and employees, and make capital investments that will allow them to continue to prosper. Profitability after filing for Chapter 11 reorganization has increased and is forecast to increase approximately back to pre-bankruptcy filing amounts.

- **Changes in the Chapter 11 companies' total assets show that they continue to be viable, on-going enterprises.**

1 Subsidiary and sole operating asset of G-I Holdings, which is the parent holding company that filed for Chapter 11 bankruptcy; BMCA has not filed for bankruptcy.

The companies' aggregate actual (adjusted to exclude asbestos insurance receivables and discontinued operations, where applicable) and forecast total assets changed only slightly from 1998 through 2005. The data indicate that filing for reorganizations did not measurably affect the assets held by the companies.

- **Total employment at these companies increased or did not decline materially.**
  Post-filing employment increased at one company, Babcock & Wilcox, by 39%. Three other companies also increased their post-filing employment. Three other companies decreased their post-filing employment - the largest decrease by Owens Corning was 10%. In the case of two companies which decreased their post-filing employment, these decreases resulted from pre-filing restructuring programs and divestitures made in the ordinary course of business and were unrelated to the Chapter 11 reorganizations.

- **All the companies met their obligations to fund employee pensions.**
  Post-Chapter 11 filing pension contributions increased substantially from \$64.5 million in 1999 to \$114.6 million in 2000 to \$243.2 million in 2001. Contributions went down in 2002 to \$107.2 million. These contributions indicate on-going funding, rather than a onetime contribution.

- **The companies should do well in the future.**
  A company's prospects for the future are indicated by its capital expenditures. The companies continued to make capital expenditures after they filed for bankruptcy reorganization, although to a lesser degree than before. The amounts are expected to increase slightly over the 2003–2005 period.

Professor Benston concludes that, even though these companies face growth constraints because of requirements to hold substantial amounts of cash and cash equivalents, the financial and employment outlook for all the companies looks strong. "Based on the financial information I analyzed, all of these measures indicate that the Chapter 11 companies are likely to continue to prosper in the future," he concluded.

Table of Contents

Financial Analysis of Companies That Filed for Chapter 11 Bankruptcy in 2000 and 2001 as a Result of Asbestos Obligations

George J. Benston[*]

In 2000 and 2001, the seven largest companies facing substantial liabilities for damages to people who were injured by asbestos products which they or their predecessors produced in earlier years filed for bankruptcy reorganization under Chapter 11. This action required the companies to operate under supervision of the Bankruptcy Court, which allowed them to continue providing their consumers with products, employees with jobs, and generate resources to pay their obligations to people injured by asbestos. The questions at issue are whether and to what extent these companies have been able to operate successfully under this condition.

The seven "Chapter 11" companies and the dates on which they filed for bankruptcy reorganization are:

Company Name	Date of Filing
Babcock & Wilcox Company	February 22, 2000
Owens Corning	October 5, 2000
Armstrong World Industries	December 6, 2000
Building Materials Corporation of America (BMCA)[1]	January 5, 2001
W.R. Grace & Co.	April 2, 2001
US Gypsum Corporation	June 25, 2001
Federal-Mogul Corporation	October 1, 2001

I examined data from the companies' 10-K annual filings with the Securities and Exchange Commission (SEC) for years around and including these companies' Chapter 11 filings—1998 through 2002. To the extent possible, I used financial statement numbers that were backward adjusted for acquisitions and dispositions. In addition, forecasts of financial data for 2003, 2004, and 2005 were obtained from the companies.

[*] Ph.D., CPA, John H. Harland Professor of Finance, Accounting and Economics, Goizueta Business School, Emory University, Atlanta, GA 30322.

[1] Subsidiary and sole operating asset of G-I Holdings, which is the parent holding company that filed for Chapter 11 bankruptcy; BMCA has not filed for bankruptcy.

The data are presented in three ways. First, the numbers are aggregated to show the magnitude of the Chapter 11 companies' operations and how these changed before and after they filed for bankruptcy. These data include the forecasts for 2003, 2004, and 2005. Since these data are confidential, they are presented only in an aggregated form. The data are presented in Figures 1 to 9.[2]

Second, data for each of the seven companies are presented in tables showing the relationship of their operations and financial condition before and after their filing for Chapter 11 bankruptcy. For this purpose, the data are "normalized," by dividing the amounts for each year by the amount in the year before the companies filed for Chapter 11 (times 100 to convert the ratios to percentages). Thus, the amount for the year before filing is equal to 100; the numbers in the year(s) before and following this year give the percentage increase or decrease relative to the pre-filing year. This allows readers to compare each company's performance before and after Chapter 11 filing and also to see the extent to which individual companies' performance differ from each other and the aggregate.

It is fair to say that they are viable and are likely to be increasingly successful companies that should generate funds to exit bankruptcy reorganization significantly stronger than when they went in.

Third, to account, at least in part, for the effect of other time-related factors over the five years studied, the Chapter 11 companies' performance is contrasted with competitors that did not declare bankruptcy, grouped into four industries: building products (Armstrong, Owens Corning, US Gypsum, and BMCA), specialty chemicals (WR Grace), automotive parts (Federal-Mogul), and power generation (Babcock & Wilcox). Data were obtained for eleven building products companies, eight specialty chemical companies, eleven automotive parts companies, and four power generation companies.[3] The comparable companies' data are aggregated and "normalized" to the same year as the Chapter 11 companies, so that their performances may be compared.

[2] Although Owens Corning filed for bankruptcy on October 5, 2000 and Armstrong on December 6, 2000, I consider 2001 to be their first bankruptcy year, because the data for 2000 largely reflect their pre-bankruptcy operations and year-end financial position. Babcock & Wilcox filed for bankruptcy on February 22, 2000. In that year, its sales and assets are only 5% and 3% of the aggregate shown on the figures. Therefore, I designated 2000 as its bankruptcy year. Thus, all the Chapter 11 companies, except for Babcock & Wilcox, have 2001 as their bankruptcy year.

[3] The names of the comparison companies are presented in Appendix A. The companies are roughly of comparable size, with the exception of Georgia Pacific. Because it represents some 40% of the aggregate of the comparable building products companies, these aggregates are shown including and excluding Georgia Pacific.

Summary of Findings

- Overall Conclusions. The Chapter 11 companies analyzed appear to have used the respite in creditor demands allowed by their bankruptcies to reverse some pre-filing downward movements in their operations. On the whole, they essentially have increased or stabilized their sales, assets, employment, and profitability, and have projected increases. It is fair to say that they are viable and are likely to be increasingly successful companies that should generate funds to exit bankruptcy significantly stronger than when they went in.

- Annual sales, total assets, and number of employees provide measures of the extent to which the Chapter 11 companies have been able to continue producing products that are purchased by consumers. The figures and tables show that the Chapter 11 companies have been able to continue their operations successfully. Indeed, with few exceptions, they have prospered, increasing their sales. They have been able to maintain their assets and employment, meet their obligations to business creditors and employees, and make capital investments that will allow them to continue to prosper. Although there are some differences among the Chapter 11 companies, total employment did not decline materially. Compared to other companies in their industries, they generally did as well or better, with some exceptions.

- Profitability, measured as earnings from operations before interest, taxes, depreciation and amortization (EBITDA), indicates the ability of companies to provide funds to meet their obligations to creditors and (for non-bankrupt companies) stockholders. Companies that file for Chapter 11, though, are faced with especially high legal and other costs related to bankruptcy, and Court-imposed restraints on their operations and holdings of liquid assets to pay claimants, which reduce profitability. Not surprisingly, therefore, the Chapter 11 companies' EBITDA decreased somewhat in the year they filed for bankruptcy, continuing a trend that began in earlier years. However, perhaps surprisingly, their profitability then increased and is forecast to increase approximately back to pre-bankruptcy filing amounts. Individually, the companies differ considerably. Two companies' profitability increased substantially, while the others' declined by varying amounts. The comparable companies' profitability also tended to decline over the same period, but not as much as did the Chapter 11 companies generally. All the Chapter 11 companies, though, remained profitable after filing for bankruptcy.

- A company's prospects for the future are indicated by its capital expenditures, which forecast its expectation and ability to improve production methods, improve and develop products, and thereby generate future net earnings and funds. The Chapter 11 companies continued to make

> capital expenditures after they filed for bankruptcy, although to a lesser degree than before. The amounts are forecast to increase slightly over the 2003–2005 period. The changes for the individual companies are mixed, with about half increasing expenditures and one decreasing expenditures substantially, reflecting the absence of additional acquisitions. In three cases, the Chapter 11 companies increased their capital expenditures more than comparable companies in their industries. In addition, the companies' forecasts of higher sales and EBITDA, and announcements of additional contracts and products indicate that they expect to do well in the future.

These findings reflect the fact that the companies studied did not file for bankruptcy because they had displeased customers, failed to compete effectively, were displaced by superior products or technology, or been ineptly managed, but because this was the only way they could continue operations, given their obligations to people injured in the past by asbestos and asbestos-related products. I draw this conclusion from analyses of the Chapter 11 companies' and their competitors' sales, assets, employment, EBITDA, capital expenditures, and announcements of future contracts and products that follow.

Sales

Annual sales provides perhaps the most important measure of the extent to which the Chapter 11 companies have been able to continue producing products that are purchased by consumers.

Figure 1 shows that the Chapter 11 companies' aggregate sales were essentially maintained following their filing for bankruptcy. They forecast increasing sales somewhat in 2003 and continuing to increase sales, at least through 2005, when the aggregate sales are expected to exceed sales for 1999, the highest sales level during the pre-filing years analyzed.

> **Annual sales provides perhaps the most important measure of the extent to which the Chapter 11 companies have been able to continue producing products that are purchased by consumers.**

Table 1 shows that the individual Chapter 11 companies generally maintained or increased their sales levels through 2002. Babcock & Wilcox's sales increased steadily and substantially over its 1999 pre-filing sales, to 141% of this amount in 2002. BMCA's and WR Grace's 2002 sales were 13% and 14% greater than their 2000 pre-filing sales. Sales at Armstrong and Owens Corning were almost unchanged. Although US Gypsum's sales in 2002 were 92% of its 2000 pre-filing sales, those sales were 6% greater than sales in 2001, a year in which sales had decreased to 87% of the previous pre-filing year. Federal-Mogul's 2001 sales decreased to 91% of its 2000 pre-filing sales, and then were almost unchanged in 2002. The initial decline appears due to a rationalization of its operations following substantial acquisitions in 1998, when it acquired Turner & Newell and the Moog automotive division of Cooper Industries, which increased its sales from $1.8 billion in 1997 to $6.5 billion in 1999, its first full year of post-acquisition operations.

Compared to companies in the same industry, the Chapter 11 companies' sales increased somewhat more or less. The specialty chemicals and power generation Chapter 11 companies' sales increased more and the building-products and auto parts Chapter 11 companies' sales increased less than their competitors.

Total Assets

Changes in the Chapter 11 companies' total assets show that they continue to be viable on-going enterprises.

As shown on Figure 2, the Chapter 11 companies' aggregate actual[4] and forecast total assets changed only slightly from 1998 through 2005. The data indicate that filing for bankruptcy did not measurably affect the assets held by the companies.

> **Changes in the Chapter 11 companies' total assets show that they continue to be viable on-going enterprises.**

Table 2 shows that the total assets of the Chapter 11 companies generally increased after they filed for bankruptcy. Babcock & Wilcox's 2002 year end assets increased by 29% over its pre-fling year-end 1999 assets. Both Armstrong and US Gypsum's 2002 year-end assets were 15% greater than their assets at the pre-fling year-end 2000. WR Grace and Owens Corning's year-end 2002 assets also increased, but only by 9% and 1% over this period. BMCA and Federal-Mogul's assets followed the same patterns as their sales. BMCA's year-end 2002 assets were 96% of its pre-filing year amount, an increase of 4% over the previous (2001) year. Federal-Mogul's assets at year-end 2002 declined to 79% of its pre-filing year 2000 amount, due to the adoption of a new accounting principle, which resulted in a significant write-off of goodwill, and material write-downs of assets associated with its 1998 acquisitions.

The Chapter 11 companies' competitors generally increased their assets at somewhat higher rates than the companies that declared bankruptcy, except for specialty chemicals. It should be noted that the Chapter 11 companies cannot grow by acquisitions for stock, because they do not have equity stock to exchange. However, several of their competitors increased asset size as a result of acquisitions. Nevertheless, as noted earlier, all but two of the Chapter 11 companies' asset growths were positive over their years in bankruptcy.

[4] Total assets are adjusted to exclude asbestos insurance receivables and discontinued operations, where applicable.

Employment

A note of caution with respect to employment numbers is necessary. Unlike sales, assets, and other amounts taken from financial statements, the number of employees as of the end of a year is not adjusted for acquisitions, mergers, and discontinued operations. Hence, employment numbers reflect changes that are due to these structural changes rather than to changes in the level and scope of on-going operations.

As shown in Figure 3, the number of people employed by the Chapter 11 companies in aggregate at year-end 2002 decreased slightly (3.4%) and insignificantly over their pre-bankruptcy-year amount, due primarily to decreases at three companies. The other four companies' employment increased or remained stable.

Table 3 shows that year-end 2002 employment at Babcock & Wilcox increased by 39% over its 1999 pre-filing year. Post-filing employment increased somewhat at Armstrong (by 7%), BMCA (by 6%), and WR Grace (by 2%), and decreased by 5% at US Gypsum and Federal-Mogul. Owens Corning experienced a 10% decline in employment. The 10-K reports of Federal-Mogul and Owens Corning identify these companies' employment decreases as resulting from pre-filing planned restructuring programs and divestitures made in the ordinary course of business.

In comparison with competitors, employment at the Chapter 11 companies increased relatively more, except for building products if the comparable companies include Georgia Pacific. Thus, overall employment at the Chapter 11 companies does not appear to have been negatively affected by their filing for bankruptcy.

Figure 4 shows that the Chapter 11 companies kept up their obligations to fund their pension obligations to their employees. Indeed, their post-filing pension contributions in 2001 increased substantially from $64.5 million in 1999 and $114.6 million in 2000 to $243.2 million in 2001, after which the contribution in 2002 came down to a still relatively high $107.2 million, which is indicative of on-going funding, rather than a one-time contribution. As a result of the downturn in the market over the last few years, it is anticipated that these companies, in particular Federal-Mogul, will have to make substantial cash outlays to cover the minimum pension requirements. These cash outlays are projected to come from normal operations of these viable companies.

> **Thus, overall employment at the Chapter 11 companies does not appear to have been negatively affected by their filing for reorganization.**

Profitability

Profitability provides a measure of the extent to which companies are successful in generating resources for their creditors and owners (and the government in the form of taxes) from their operations. I examine a commonly used measure, EBITDA, earnings from operations before interest, taxes, depreciation, and amortization. I exclude asbestos-related litigation expenses and insurance recoveries and Chapter 11 filing and reorganization expenses. However, costs incurred as a result of a diversion of executive time to deal with the bankruptcy filings and Court-imposed restrictions on acquisitions and uses of funds that are restricted for the benefit of asbestos claimants, probably negatively affected the Chapter 11 companies. Hence, the profitability of their regular operations in comparison with other companies is biased downward.

In addition to EBITDA alone, I present two standard means of adjusting the numbers for the scale of a company's operations and resources—EBITDA as a percentage of sales and EBITDA as a percentage of total assets (adjusted as described in footnote 4). These measures are calculated by adding up each company's sales or assets and then dividing the sums into the aggregate EBITDA (and then multiplying by 100 to convert the ratios to percentages). Both percentages account for changes in EBITDA that are due primarily to increases in company size.

Figures 5, 6, and 7 present aggregates for the Chapter 11 companies. The patterns for all three measures of profitability are similar. EBITDA (expressed as an amount or as a percentage of sales or assets) is highest for 1999, decreases somewhat in the first bankruptcy year, 2001, and is projected to increase to about the pre-bankruptcy 2000 number by 2005. The substantial increase in 1999 is due entirely to Federal-Mogul, whose 1999 EBITDA of $1,180,000 (which includes the first full year of its 1998 acquisitions) is almost twice the $697,000 reported for 1998. In 2000, when Federal-Mogul actually filed for bankruptcy on October 1, its EBITDA was $834,000, after which it declined and stabilized to $502,000 and $500,000 in 2001 and 2002, respectively. Its EBITDA/sales and EBITDA/total assets percentages follow the same pattern.

Based on the financial information I analyzed, all of these measures indicate that the Chapter 11 companies are likely to prosper in the future.

Table 4, 5, and 6 present the individual Chapter 11 company data for each company, normalized to compare the year(s) before and after their filing for bankruptcy. The three measures of profitability yield similar results. Individual companies, though, differ substantially. Two companies' profitability has increased substantially during bankruptcy—BMCA by 37%–61% and Babcock & Wilcox by 33%–46%, depending on the metric. The other Chapter 11 companies have been less profitable. However measured, none of them experienced more than a 47% drop in profitability, and most had about a 25% reduction.

Profitability of comparable specialty chemicals and automotive parts companies also declined over the period, but not as much as did the Chapter 11 companies. Measured as EBITDA alone, the comparable building products companies (including or excluding Georgia Pacific) improved, while measured as a percentage of sales or assets, their profitability declined or was almost unchanged. However, for all three measures, the comparable building products companies were more profitable than the Chapter 11 companies. Profitability of the power generation comparable companies increased, but not as much as did Babcock & Wilcox. As percentages of sales or assets (which, considering the substantial increases in sales and assets over the period, are more relevant numbers), the comparable companies' profitability declined slightly, while Babcock and Wilcox's increased substantially.

Prospects for the Future

The prospects for the future of an enterprise may be estimated in three ways: forecast sales, assets, and EBITDA; past and forecast capital expenditures (which provide the means for future production, productivity improvements and new and improved products); and announcements of contracts and new products. Based on the financial information I analyzed, all of these measures indicate that the Chapter 11 companies are likely to prosper in the future.

- Forecasts: Sales are projected by the companies in their internal reports to increase over 2003 through 2005, from $21.6 billion in 2002 to $23.4 billion in 2005 (see Figure 1). Assets are expected to increase slightly, from $26.0 billion in 2002 to $26.8 billion in 2005 (see Figure 2). EBITDA and EBITDA as percentages of sales and total assets are projected by the companies to increase substantially over 2002, bringing them close or better than their pre-bankruptcy levels (see Figures 5, 6, and 7).
- Capital expenditures are projected to continue in the future, although at a somewhat lower amount than before the Chapter 11 companies filed for bankruptcy. The amounts invested were lower during the bankruptcy years (2001 and 2002), but were still substantial, as shown by Figure 8. These expenditures are projected to increase slightly in 2003 through 2005. Three of the seven Chapter 11 companies' capital expenditures were higher in 2002 than in their pre-bankruptcy year. The capital expenditures of one of the seven (US Gypsum) decreased substantially. The other building product companies' capital expenditures increased about the same as or more than comparable companies. WR Grace, Federal-Mogul and Babcock & Wilcox invested much more than comparable companies. Overall, the data on capital expenditures shows that the Chapter 11 companies expect to continue to be viable—indeed, to continue expanding their operations.

The Chapter 11 companies have been and expect to remain strong industry competitors and leaders.

- Announcements of contracts and plans for long-run growth and investments in new technologies taken from press releases and management statements included in SEC 10-K reports, quoted in Appendix B, indicate that the Chapter 11 companies have been and expect to remain strong industry competitors and leaders.

Bankruptcy-imposed Constraint on Profitability and Growth

Chapter 11 bankruptcy has limited the seven corporations analyzed by requiring them to hold substantial amounts of cash and cash equivalents (e.g., marketable debt securities) to pay asbestos claimants and, for Federal-Mogul, as required by the U.K. Administration. These assets offer low returns, as production companies have no comparative advantage holding or trading securities. Hence, to the extent that the Chapter 11 companies must hold cash and cash equivalents in excess of the amounts they would hold in the ordinary course of business, their profitability and ability to purchase productive (capital) assets is decreased.

Figure 9 presents the aggregate amounts of cash and cash equivalents held by the seven Chapter 11 companies in each of the five years surrounding their filing for bankruptcy. All of the Chapter 11 companies' increased their cash holdings substantially after filing for bankruptcy. To compare the companies' pre- and post-filing cash holdings, I averaged their 1998 and 1999 aggregate amounts ($540 million) and their 2001 and 2002 aggregate amounts ($2,666 million). The amounts for 2001–2002 increased by 494% over 1998–1999. This substantially greater holding of less-productive assets surely decreased the profitability of the Chapter 11 companies and reduced their capital expenditures.

It also should be noted that, as a result of the strong operations, as described in Appendix B (i), some of the Chapter 11 companies reduced their available debtor-in-possession credit facilities, which reduces the financing costs on the undrawn revolvers.

A Note on Measurements

Comparable Company Analysis

To account, to the extent possible, for changes in the markets for the Chapter 11 companies' products, the following procedures were followed. First, the products sold were identified from descriptions in 10-Ks and company documents. Then, companies that also produced these products were identified. Senior company executives were interviewed; they identified the names of their principal competitors. Additional names were obtained from four-digit Standard Industrial Code (SIC) listings and the Hoover.com database. Companies that did not file 10-K reports could not be included.

The competitor companies identified are far from perfect matches, which limits the conclusions that can be drawn from the comparisons. In particular, within the buildings material group, one competitor—Georgia Pacific—provides about a third to a half of the sales, assets, etc. (depending on the measure and the year). Consequently, I show the other ten companies separately in the Tables. In fact, this does not change the measured relationships much. Growth, apparently by acquisitions, affected the comparable company data. In general, there are a sufficient number of observations to obviate this measurement, the exception being power generation (Babcock & Wilcox). Three of the four competitors' 2002 assets were 400%, 310%, and 690%of the amount of their 1998 assets; one decreased by 6%. In addition, Babcock & Wilcox underwent substantial changes, as indicated by the variance of its numbers. Hence, this comparison has limited value.

Employment

This report includes most of the employees of companies that filed for bankruptcy in what Joseph E. Stiglitz, Jonathan M. Orszag, and Peter R. Orszag (Sebago Associates) describe as the "fourth wave". In their December 2002 report, ***The Impact of Asbestos Liabilities on Workers in Bankrupt Firms,*** commissioned by the American Insurance Association, Stiglitz et al. delineate four "waves" of asbestos-related bankruptcies. The fourth wave, which covers the years 1998-2002 and includes 24 companies, employed 136,831 employees "before bankruptcy filing," 67% of the total number of employees of all asbestos-related companies that declared bankruptcy from 1978 through 2002 (ibid, Table 3, p.17). The seven companies analyzed herein had 117,710 employees in 2000, 86% of the 136,831.

Stiglitz et al.'s principal finding is that workers in firms declaring asbestos-related bankruptcy after 1998 lost 27,419 jobs over the five years *before* bankruptcy, after adjusting for changes in industry employment (ibid, Table 7, p. 26).[5] They did not determine how many jobs were lost as a result of the asbestos-liability firms declaring bankruptcy or were lost after they filed for bankruptcy. I found that the number of employees at the seven Chapter 11 companies I study declined by 4,000 (3.4%) during their bankruptcy years, 2000 and 2002 (see my Figure 3). Furthermore, employment at four of the seven companies increased compared to the year before they filed for bankruptcy, two declined by 5%, and one by 10%. In general, changes in the seven Chapter 11 companies' employment numbers were relatively higher than those of comparable companies compared to the year(s) before they filed for bankruptcy, as shown by my Table 3.

5 They also calculate the loss of retirement benefits to workers whose retirement funds include stock in their own companies. All stockholders of these companies, though, incurred such losses. The only measure of the performance of Chapter 11 companies included in their study is based on the stock prices of 13 companies that declared bankruptcy sometime before September 2002 for which data for a ten-year period are available. Not surprisingly, because bankruptcy reduces and usually eliminates the market value of shares, the stock prices of these companies (expressed as an index) declined over the ten years almost to zero (see their Chart 4, p. 32). The decline probably reflects the reduction in the prices of the individual companies at or around the time the filed for bankruptcy. Stiglitz et al. do not measure (nor do they say they measure) the actual bankruptcy performance of Chapter 11 companies.

About the Author

GEORGE J. BENSTON is the John H. Harland Professor of Finance, Accounting, and Economics in the Goizueta Business School and Professor of Economics in the College of Arts and Sciences of Emory University, and Honorary Visiting Professor at City University (London). At Emory, he also has served as Coordinator of both the Finance and Accounting Areas and as Associate Dean for Research and Faculty Development. Before coming to Emory in 1987, he was on the faculties of the University of Rochester and the University of Chicago, and has been the John M. Olin Distinguished Visiting Fellow at Oxford University and a visiting professor at the London School of Economics, the London Graduate School of Business Studies, Hebrew University and Berkeley. He received his Ph.D. from the University of Chicago, M.B.A. from New York University, and B.A. from Queens College. He also is a Certified Public Accountant (North Carolina). The honors he has received include Distinguished Scholar Award, 2003 (Eastern Finance Association), Adam Smith Award 2002 (jointly with George Kaufman and Edward Kane, National Association of Business Economists), Henry Thornton Lecturer (19th) 1997 (City University, London, UK), and Distinguished International Lecturer 1980 (American Accounting Association). Professor Benston presently serves an associate editor of the *Journal of Money, Credit and Banking, Journal of Applied Corporate Finance, Research in Financial Services Annual, Accounting and Public Policy, and Issues in Accounting Education,* and was co-editor of the *Journal of Financial Services Research* from its founding in 1987. He also is a member of the Shadow Financial Regulatory Committee and the Financial Economists' Roundtable.

Professor Benston has published over 150 books, monographs, and articles in refereed academic journals in accounting, finance and economics. This work concerns the regulation of financial institutions, services, and markets, the structure and competitiveness of banking and financial markets, SEC financial disclosure, economies of scale in banking, savings and loan and bank failures, mortgage "redlining", industrial organization and antitrust economics, and racial and gender discrimination in lending and annuities. His books include *Following the Money: The Enron Failures and the State of Corporate Disclosure* (with Robert Litan, Michael Bromwch, and Alfred Wagenhofer, Brookings Institution, 2003), *Regulating Financial Markets: A Critique and Some Proposals* (American Enterprise Institute, 1999), and *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered* (Oxford Univ. Press, 1990).

In addition to academic research, he has consulted for and worked with the principal banking regulatory agencies (e.g., FDIC, Federal Reserve, Comptroller of the Currency) and testified before several committees of the US Congress and regulatory bodies (e.g., House and Senate Banking Committees, Securities and Exchange Commission, and the Financial Accounting Standards Board). Most recently, he has been an advisor on accounting to the Examiner in Bankruptcy, Enron Corporation. Prior to entering academia, he was employed in pubic accounting and in banking.

Appendix A

Comparable Companies By Industry

Building Products
American Woodmark
ElkCorp
Georgia Pacific
Interface
Lafarge North America
Masco
Mohawk Industries
NCI Building Systems
Nortek
PPG Industries
Universal Forest Products

Automotive Parts
American Axle
ArvinMeritor
Borg Warner
Dana Corporation
Delphi
Dura Automotive
Eaton
Johnson Controls
Lear
Stoneridge
Tenneco

Specialty Chemicals
Albemarle Corp.
Crompton Corp.
Cytec Industries
Engelhard Corp.
Great Lakes Chemical
Hercules Incorporated
Lubrizol Corp.
Rohm & Haas

Power Generation
Flowserve
Fluor
Jacobs Engineering
The Shaw Group

Appendix B

Performance and Prospects of Chapter 11 Companies Derived from Press Releases and Form 10-Ks Filed with the Securities and Exchange Commission

During bankruptcy, many Chapter 11 companies have achieved the following:

a. Received various quality-related awards
   - Federal-Mogul Press Release 6/30/03—"Federal-Mogul Corporation was recently named "Supplier of the Year 2002" by Yamaha South America. The award recognizes Yamaha suppliers that had an outstanding performance in quality, delivery, product development and overall customer service in 2002".
   - Federal-Mogul Press Release 6/27/03—"Federal-Mogul earned the distinction of "Manufacturer of the Year," from the program group Independent Auto Parts of America (IAPA)."

b. Been awarded large new contracts
   - B&W Press Release 12/11/02—"Babcock & Wilcox Canada Wins $280 Million Contract for Coleson Cove"
   - B&W Press Release 6/6/02—"Babcock & Wilcox Awarded US$105 Million Construction Project"
   - B&W Press Release 1/22/01—Babcock & Wilcox Awarded $100 Million Contract to Build New Coal-Fired Power Plant in Wyoming "This is a significant development, and we are pleased to have been selected as their extended-scope contractor for this vital project," said James F. Wood, president of Babcock & Wilcox.

c. Maintained their industry leadership position, often with #1 or #2 market share
   - Federal-Mogul Press Release 4/22/02—"Our ability to bolster market leadership in a period of industry uncertainty is related to our strong brands, new product technology, and continued improvement in delivery performance to industry-leading levels," said Chip McClure, Federal-Mogul's chief executive officer and president.
   - BMCA 12/31/02 10-K—"Building Materials Corporation of America is a leading national manufacturer of a broad line of asphalt and polymer based roofing products and accessories for the residential and commercial roofing markets. We are a lead-

ing manufacturer of a complete line of premium residential roofing products. We believe that we are the largest manufacturer of both asphalt built-up roofing products and modified bitumen products in the United States."

- US Gypsum 12/31/02 10-K—"Through its subsidiaries, the Corporation is a leading manufacturer and distributor of building materials producing a wide range of products for use in new residential, new nonresidential, and repair and remodel construction, as well as products used in certain industrial processes. U.S. Gypsum is the largest manufacturer of gypsum wallboard in the United States and accounted for approximately one-third of total domestic Gypsum wallboard sales in 2002. The Corporation competes in North America as the largest of 10 producers of gypsum wallboard products and in 2002 accounted for approximately one-third of total gypsum wallboard sales in the United States."
- WR Grace 12/31/02 10-K—"Grace believes that Davison is one of the world leaders in refinery catalysts and the largest supplier of FCCs in the world."
- Armstrong Press Release 5/23/03—"Armstrong World Industries, Inc. is a global leader in the design and manufacture of floors, ceilings and cabinets."
- Owens Corning Press Release 8/12/03—"Owens Corning is a world leader in building materials systems and composite systems."

d. Focused on a long-term growth strategy

- Federal-Mogul 12/31/02 10-K—"The Company has pursued a growth strategy focusing on its core competencies of manufacturing and engineering by concentrating efforts and resources on core business segments that will provide long-term growth."
- US Gypsum 2Q Earnings Release 7/29/03—"We continued to grow and strengthen our core businesses during the quarter by focusing on customer service, operating efficiencies and selective growth opportunities," said USG Corporation Chairman, CEO and President William C. Foote. "These improvements were not fully reflected in our bottom line, though, due to higher cost factors, especially the rise in natural gas prices. These cost pressures are likely to continue in the near term, and the corporation is focusing on ways to offset them."
- WR Grace 12/31/02 10-K—"In addition to new product introductions, product enhancements and acquisitions, Grace looks for growth opportunities in developing countries, where increases in construction activity and sophistication of construction practices can increase demand for Grace's construction chemicals and building materials products. Grace seeks to increase profitability and minimize the impact of cyclical down-

turns in regional economies by introducing technically advanced higher-performance products, expanding geographically, and developing business opportunities in renovation construction markets."

- Armstrong 3Q Earnings Release 11/9/01—"While we continue to be affected by the economic downturn, we are investing in our core businesses," said Armstrong Chairman and CEO Michael D. Lockhart. "We remain focused on improving the cost structure, product offerings and long-term profitability of the business."

e. Continued investment in technology with realized productivity gains

- Federal-Mogul 2Q Earnings Release 7/29/03—"We remain on course with our strategic plan and I'm pleased with our execution, especially in the areas of cash flow and productivity. Through productivity, we have been able to offset industry pricing pressures, increased pension expense and inflation" said Chip McClure, Federal-Mogul's chief executive officer and president.
- US Gypsum 2002 Earnings Release 2/4/03—US Gypsum Corporation Chairman, President and CEO, William C. Foote, commenting on the results of the past year. "In our gypsum business, we made capital investments to add capacity for our SHEETROCK(r) Brand joint compounds and DUROCK(r) Brand cement board products. Both product lines, as well as USG's SHEETROCK(r) Brand gypsum wallboard, achieved record shipments during the year."

f. Continued investments in research and development and customer service for potential long-term growth

- Federal-Mogul Press Release 1/20/03—"The 40-year-mark represents the commitment of Federal-Mogul to constantly improve operations by focusing on leading-edge research and development," said James Toth, facility manager. "Some corporations are quick to reduce their research and development (R&D) investment during periods of challenging market or economic conditions, but Federal-Mogul has realized the long-term benefits and opportunities created by continuously updating our technology."
- WR Grace 12/31/02 10k—"Grace's strategy has been, and will continue to be, to seek to enhance enterprise value by profitably growing its specialty chemicals businesses globally and achieving high levels of financial performance. To achieve these objectives, Grace plans to (i) invest in research and development activities, with the goals of introducing new high-performance products and services and enhancing manufacturing processes; (ii) implement process and productivity improvements and cost-

management initiatives (including the use of Six Sigma processes) such as rigorous controls on working capital and capital spending; and (iii) pursue selected acquisitions and alliances. These plans are designed to make Grace a high-performance company focused on the strengths of its global specialty chemicals businesses."

- US Gypsum Q1 Press Release 4/24/03—"USG achieved solid results in the first quarter," reported US Gypsum Corporation Chairman, President and CEO William C. Foote. "Demand for most of our products and services continued to be strong and USG's operating units remained focused on implementing their plans for improving customer service, increasing operating efficiencies and growing their businesses. We did face significantly higher energy costs during the quarter, but we were able to partially offset their negative impact with productivity improvements and our energy hedging program."

g. Continued investment in cost reduction programs, such as Six Sigma, to improve operating margins in a difficult environment

- WR Grace 1Q Earnings Release 4/22/03—"The first quarter presented unique challenges for a global company like Grace," said Grace Chairman, President and Chief Executive Officer Paul J. Norris. "The weaker dollar helped our reported sales, but the continued softness in the economy yielded little in the way of real growth. Our costs and expenses were adversely affected by war-related uncertainties, added pension costs and abnormally high manufacturing costs, partially due to the severe winter in the U.S. Our challenge for the rest of the year is to maximize the benefits from our productivity and six sigma activities, and to capitalize on what we hope will be improving economic conditions."
- Owens Corning 12/31/02 10-K—"The Company spent a significant amount of time reviewing its cost structures in 2001 as a response to the impact of the weaker economy. During 2000, the Company recorded pretax charges of $229 million for restructuring and other activities as a result of its reassessment of business strategies with respect to investments in certain ventures, facilities and overhead expenditures."
- US Gypsum 3Q Earnings Release 10/24/02—William C. Foote, US Gypsum Corporation Chairman, CEO and President stated, "Despite the softness in the economy this year, our businesses have become stronger due to their focus on fundamentals. This includes efforts to improve customer service, reduce production costs and use working capital more efficiently. Through the first nine months of the year, we are exceeding our goals in essentially all areas, and that success has contributed to USG's improving levels of profitability."

h. Continued strategic fit acquisitions and divestitures

- Federal-Mogul 12/31/02 10-K—"In August 2001, the Company acquired 85% of WSK Gorzyce, S.A., a leading Polish producer of pistons and other automotive components. WSK employs 2,500 employees at its manufacturing location in Gorzyce, Poland with annual sales of approximately $50 million"
- Federal-Mogul 12/31/02 10-K—"In November 2002, the Company completed the divestiture of Federal-Mogul Camshafts de Mexico S. de R.L. de C.V. (*"Camshafts de Mexico"*), to Linamar Corporation. Camshafts de Mexico manufactures camshafts for the North American original equipment market."
- WR Grace 12/31/02 10-K—"In March 2002, Grace acquired the assets of Addiment, Incorporated, a leading supplier of specialty chemicals to the concrete paver and masonry industries in the U.S. and Canada."
- Owens Corning 12/31/02 10-K—"During the first quarter of 2001, the Company completed the sale of the majority of its Engineered Pipe Business, a producer of glass-reinforced plastic pipe with operations mostly in Europe."

i. Reduced borrowing requirements

- Armstrong Press Release 5/31/01- Leonard Campanaro, Armstrong's Senior Vice President and Chief Financial Officer said: "As we move through the reorganization process, we are becoming increasingly confident of our ability to fund our businesses with cash generated from operations, particularly in light of the fact that Company wide we had built up cash on hand from our operations in excess of $150 million as of April 30, 2001. We have not needed to use the Credit Facility in the first six months of our Chapter 11 case, which is the period when we expected we might have the greatest potential need. Since there are no borrowings against the facility and we do not currently anticipate any in the future, we concluded that a $200 million facility is more than sufficient to meet our foreseeable liquidity needs. As a result, we are pleased with this reduction of the facility and the resulting significant savings in related fees."
- US Gypsum 12/31/02 10-K—"In January 2003, the Corporation reduced the size of the DIP Facility to $100 million. This action was taken at the election of the Corporation due to the levels of cash and marketable securities on hand and to reduce costs associated with the DIP Facility. The resulting DIP Facility will be used largely to support the issuance of standby letters of credit needed for the Corporation's business operations."

Figure 1. Aggregate Sales of the Seven Largest Chapter 11 Companies with Asbestos Overhang

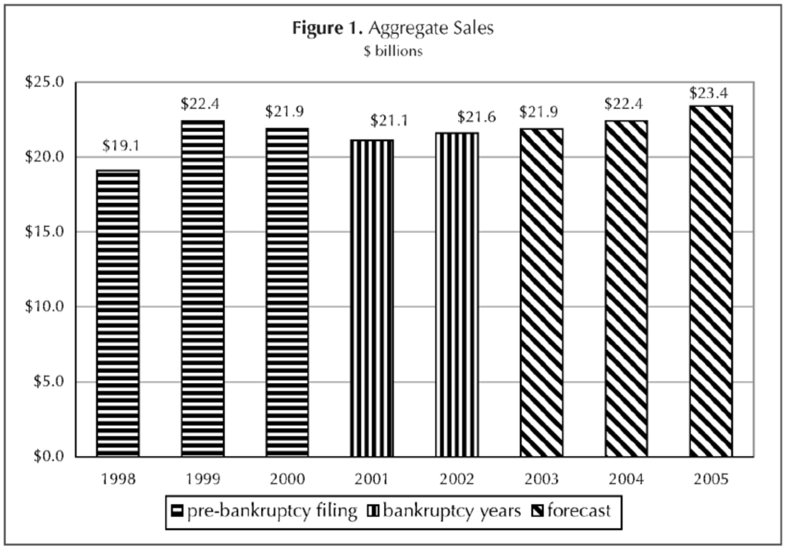


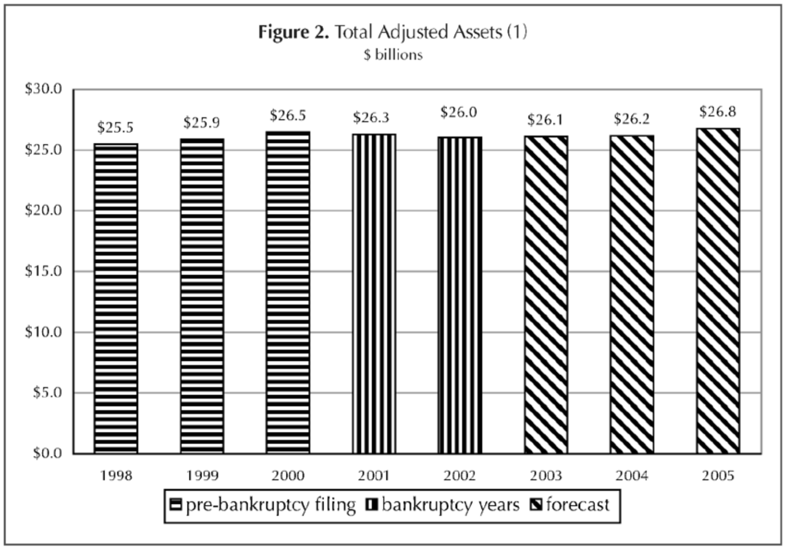
Table 1. Sales, Comparative Analysis of Chapter 11 and Comparable Companies

Relative to Year Before Bankruptcy = 100 for both Chapter 11 and Comparable Companies

	1998	1999	2000	2001	2002
Building Products Industry					
Armstrong (1)	77	102	100	97	98
Owens Corning (1)	102	103	100	97	99
US Gypsum	88	101	100	87	92
Building Materials Corp. of America (2)	90	94	100	107	113
Aggregate Building Products	91	101	100	95	98
Comparable companies					
Including Georgia Pacific	75	89	100	108	109
Excluding Georgia Pacific	84	93	100	104	112
Specialty Chemicals Industry					
WR Grace	97	97	100	108	114
Comparable companies	76	89	100	91	85
Automotive Parts Industry					
Federal-Mogul	74	108	100	91	90
Comparable companies	83	97	100	96	100
Power Generation Industry					
Babcock & Wilcox	107	100	109	135	141
Comparable companies	106	100	100	108	131

(1) Armstrong filed for bankruptcy on December 6, 2000 and Owens Corning on October 5, 2000.
(2) Sole operating asset of G-I Holdings, which filed for bankruptcy on January 5, 2001; assumed here filed in 2000.

Figure 2. Total Adjusted Assets of the Seven Largest Chapter 11 Companies with Asbestos Overhang



(1) Total adjusted assets exclude asbestos insurance receivables and discontinued operations where applicable

Table 2. Total Assets (Adjusted), Comparative Analysis of Chapter 11 and Comparable Companies (1)

Relative to Year Before Bankruptcy = 100 for both Chapter 11 and Comparable Companies

	1998	1999	2000	2001	2002
Building Products Industry					
Armstrong (2)	105	94	100	102	115
Owens Corning (2)	70	94	100	103	101
US Gypsum	67	85	100	109	115
Building Materials Corp. of America (2)	112	116	100	92	96
Aggregate Building Products	81	93	100	103	107
Comparable companies					
Including Georgia Pacific	61	74	100	96	101
Excluding Georgia Pacific	79	92	100	103	119
Specialty Chemicals Industry					
WR Grace	95	95	100	101	109
Comparable companies	67	102	100	93	83
Automotive Parts Industry					
Federal-Mogul	110	106	100	92	79
Comparable companies	79	97	100	97	98
Power Generation Industry					
Babcock & Wilcox	218	100	103	109	129
Comparable companies	96	100	102	115	132

(1) Total adjusted assets exclude asbestos insurance receivables and discontinued operations where applicable
(2) Armstrong filed for bankruptcy on December 6, 2000 and Owens Corning on October 5, 2000.
(3) Sole operating asset of G-I Holdings, which filed for bankruptcy on January 5, 2001; assumed here filed in 2000.

Figure 3. Number of Employees at the Seven Largest Chapter 11 Companies with Asbestos Overhang

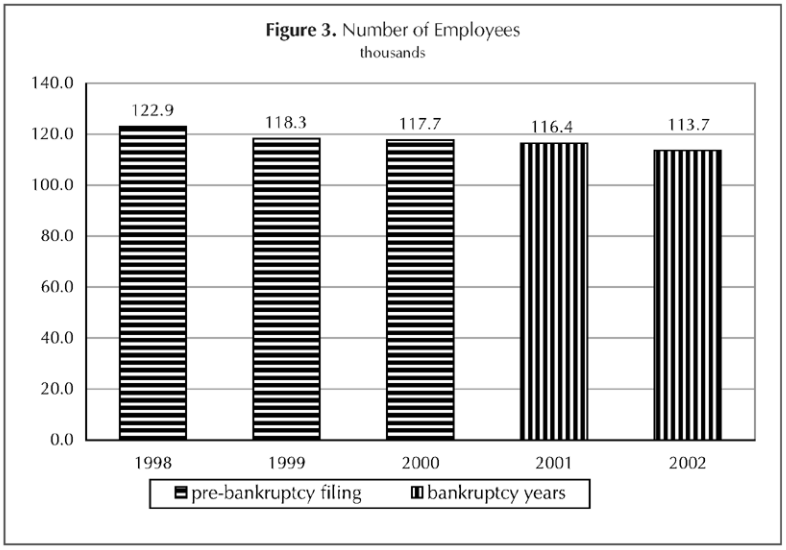


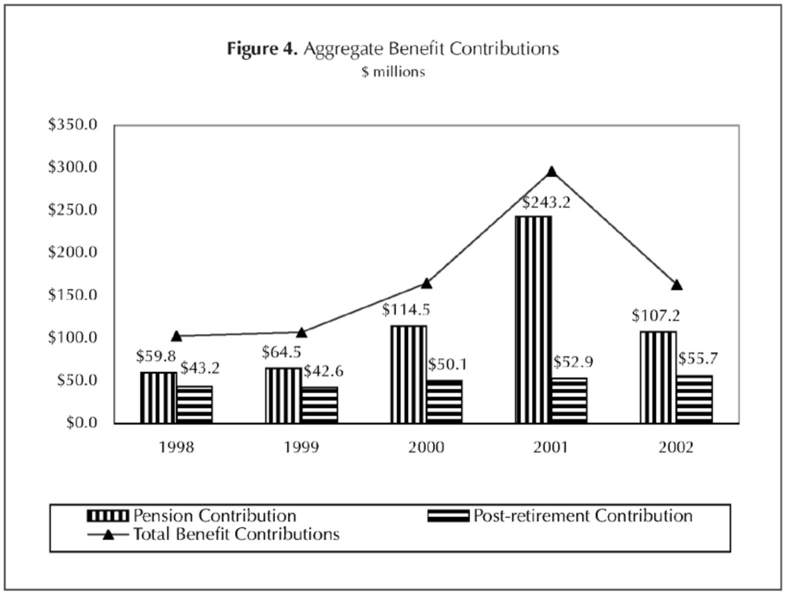
Table 3. Number of Employees, Comparative Analysis of Chapter 11 and Comparable Companies

Relative to Year Before Bankruptcy = 100 for both Chapter 11 and Comparable Companies

	1998	1999	2000	2001	2002
Building Products Industry					
Armstrong (1)	123	119	100	108	107
Owens Corning (1)	100	100	100	95	90
US Gypsum	92	96	100	96	95
Building Materials Corp. of America (2)	103	109	100	106	106
Aggregate Building Products	104	105	100	100	97
Comparable companies					
Including Georgia Pacific	70	85	100	103	100
Excluding Georgia Pacific	78	90	100	108	111
Specialty Chemicals Industry					
WR Grace	100	100	100	102	102
Comparable companies	94	109	100	99	89
Automotive Parts Industry					
Federal-Mogul	109	101	100	98	95
Comparable companies	85	100	100	93	91
Power Generation Industry					
Babcock & Wilcox	117	100	144	139	139
Comparable companies	100	100	110	120	124

(1) Armstrong filed for bankruptcy on December 6, 2000 and Owens Corning on October 5, 2000.
(2) Sole operating asset of G-I Holdings, which filed for bankruptcy on January 5, 2001; assumed here filed in 2000.

Figure 4. Aggregate Benefit Contributions of the Seven Largest Chapter 11 Companies with Asbestos Overhang



Note: 1998-2000 pre-bankruptcy filing years and 2001-2002 bankruptcy years

Figure 5. Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) of the Seven Largest Chapter 11 Companies with Asbestos Overhang

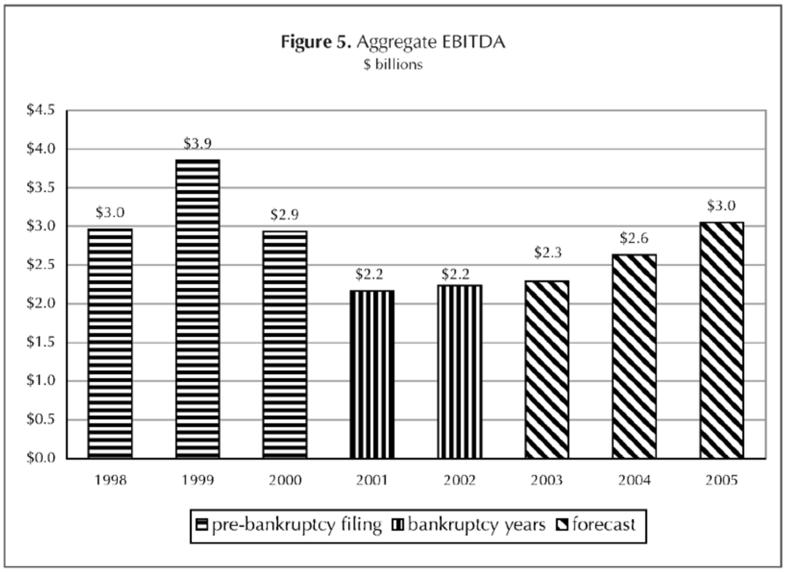


Table 4. Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), Comparative Analysis of Chapter 11 and Comparable Companies

Relative to Year Before Bankruptcy = 100 for both Chapter 11 and Comparable Companies

	1998	1999	2000	2001	2002
Building Products Industry					
Armstrong (1)	110	135	100	77	71
Owens Corning (1)	111	130	100	94	83
US Gypsum	106	131	100	39	60
Building Materials Corp. of America (2)	106	121	100	137	155
Aggregate Building Products	109	131	100	73	76
Comparable companies					
Including Georgia Pacific	86	98	100	101	101
Excluding Georgia Pacific	90	94	100	93	105
Specialty Chemicals Industry					
WR Grace	79	98	100	92	88
Comparable companies	80	97	100	73	79
Automotive Parts Industry					
Federal-Mogul	84	142	100	60	60
Comparable companies	67	98	100	79	86
Power Generation Industry					
Babcock & Wilcox	171	100	35	144	188
Comparable companies	100	100	112	112	127

(1) Armstrong filed for bankruptcy on December 6, 2000 and Owens Corning on October 5, 2000.
(2) Sole operating asset of G-I Holdings, which filed for bankruptcy on January 5, 2001; assumed here filed in 2000.

Figure 6. Aggregate EBITDA as a Percentage of Sales of the Seven Largest Chapter 11 Companies with Asbestos Overhang

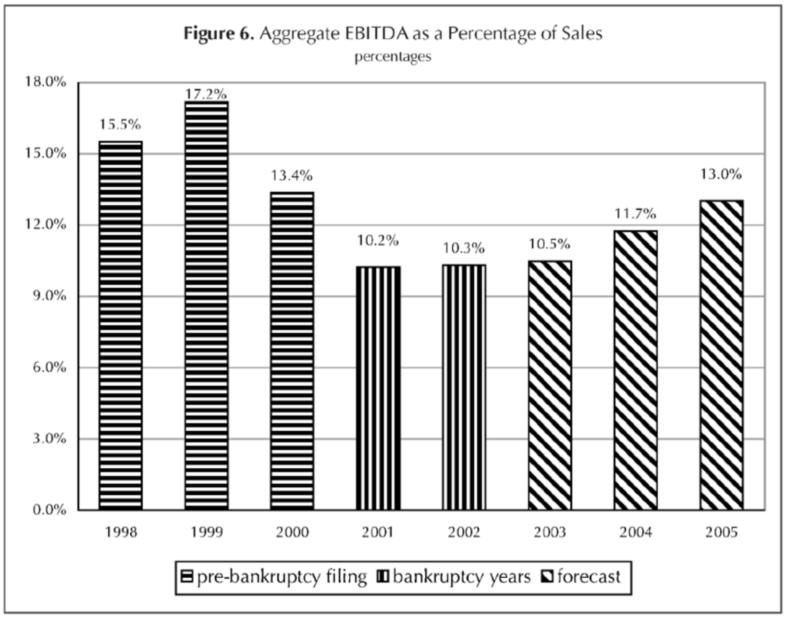


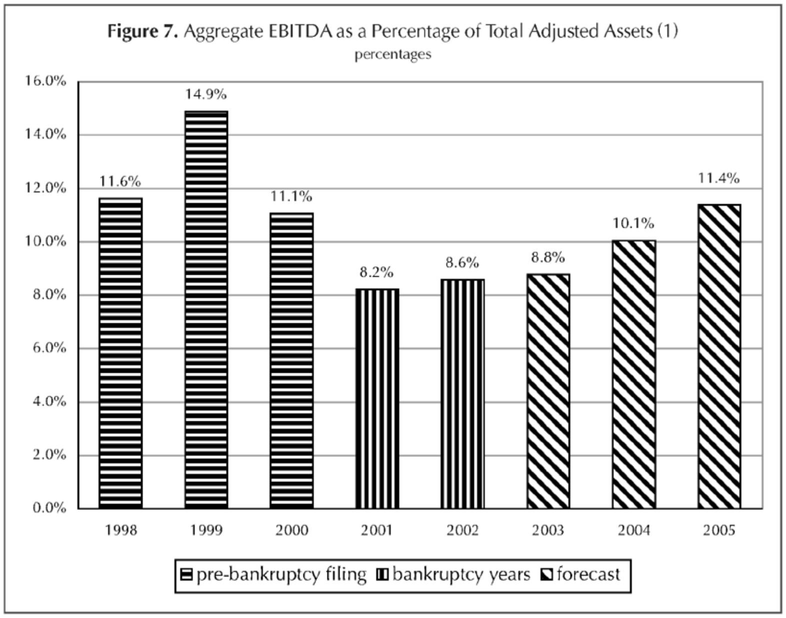
Table 5. EBITDA as a Percentage of Sales, Comparative Analysis of Chapter 11 and Comparable Companies

Relative to Year Before Bankruptcy = 100 for both Chapter 11 and Comparable Companies

	1998	1999	2000	2001	2002
Building Products Industry					
Armstrong (1)	143	132	100	80	72
Owens Corning (1)	108	126	100	97	84
US Gypsum	120	130	100	44	66
Building Materials Corp. of America (2)	117	128	100	128	137
Aggregate Building Products	120	129	100	77	78
Comparable companies					
Including Georgia Pacific	114	111	100	93	93
Excluding Georgia Pacific	107	102	100	89	94
Specialty Chemicals Industry					
WR Grace	81	101	100	85	77
Comparable companies	106	109	100	80	93
Automotive Parts Industry					
Federal-Mogul	112	131	100	66	66
Comparable companies	81	101	100	82	86
Power Generation Industry					
Babcock & Wilcox	161	100	32	107	133
Comparable companies	95	100	112	104	96

(1) Armstrong filed for bankruptcy on December 6, 2000 and Owens Corning on October 5, 2000.
(2) Sole operating asset of G-I Holdings, which filed for bankruptcy on January 5, 2001; assumed here filed in 2000.

Figure 7. Aggregate EBITDA as a Percentage of Total Assets (Adjusted) of the Seven Largest Chapter 11 Companies with Asbestos Overhang



(1) Total adjusted assets exclude asbestos insurance receivables and discontinued operations where applicable

Table 6. EBITDA as a Percentage of Total Assets (Adjusted), Comparative Analysis of Chapter 11 and Comparable Companies

Relative to Year Before Bankruptcy = 100 for both Chapter 11 and Comparable Companies

	1998	1999	2000	2001	2002
Building Products Industry					
Armstrong (1)	104	144	100	75	61
Owens Corning (1)	158	139	100	92	82
US Gypsum	159	154	100	35	53
Building Materials Corp. of America (2)	94	104	100	150	161
Aggregate Building Products	134	141	100	70	71
Comparable companies					
Including Georgia Pacific	141	133	100	105	101
Excluding Georgia Pacific	114	103	100	90	88
Specialty Chemicals Industry					
WR Grace	82	103	100	92	81
Comparable companies	120	95	100	79	95
Automotive Parts Industry					
Federal-Mogul	76	133	100	65	76
Comparable companies	85	101	100	81	88
Power Generation Industry					
Babcock & Wilcox	79	100	34	132	146
Comparable companies	104	100	109	98	96

(1) Armstrong filed for bankruptcy on December 6, 2000 and Owens Corning on October 5, 2000.
(2) Sole operating asset of G-I Holdings, which filed for bankruptcy on January 5, 2001; assumed here filed in 2000.

Figure 8. Aggregate Capital Expenditures of the Seven Largest Chapter 11 Companies with Asbestos Overhang

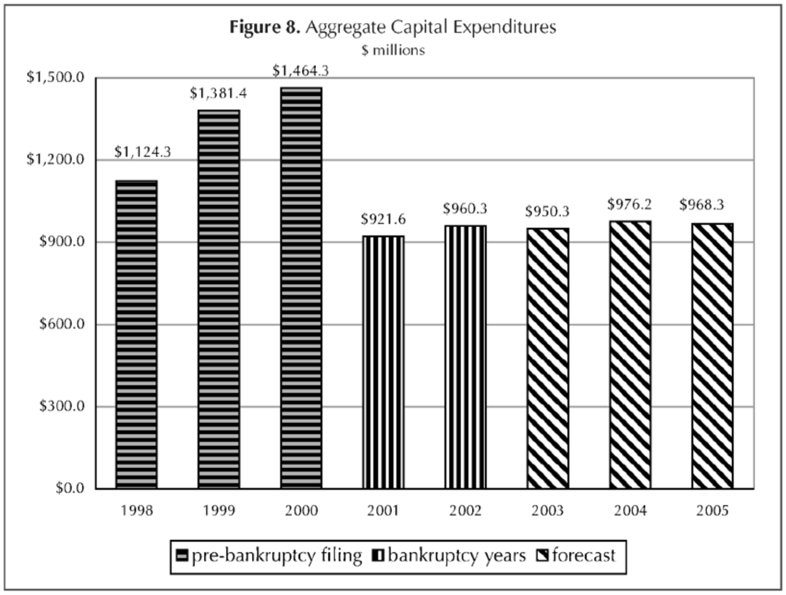


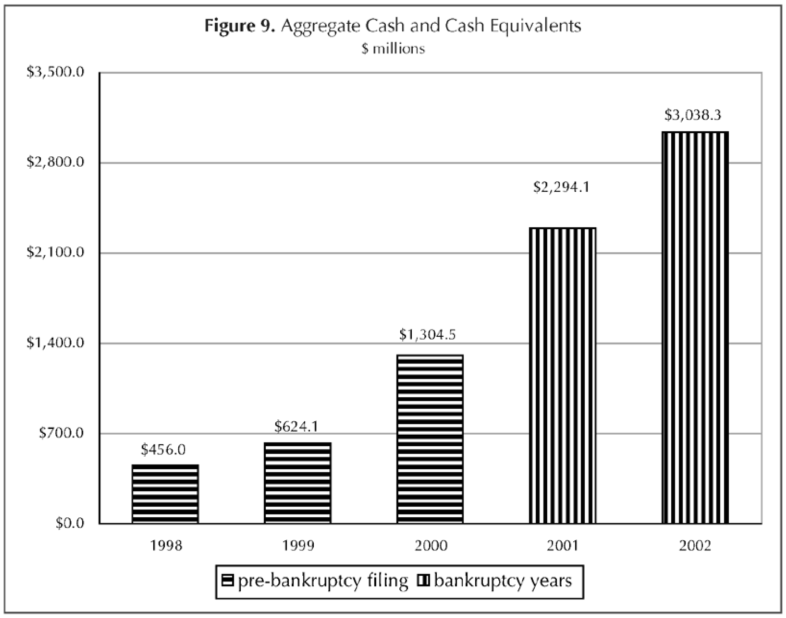
Table 7. Capital Expenditures, Comparative Analysis of Chapter 11 and Comparable Companies

Relative to Year Before Bankruptcy = 100 for both Chapter 11 and Comparable Companies

	1998	1999	2000	2001	2002
Building Products Industry					
Armstrong (1)	93	110	100	80	79
Owens Corning (1)	53	51	100	57	52
US Gypsum	81	112	100	29	26
Building Materials Corp. of America (2)	122	74	100	46	56
Aggregate Building Products	73	83	100	50	47
Comparable companies					
Including Georgia Pacific	71	86	100	72	66
Excluding Georgia Pacific	71	89	100	66	61
Specialty Chemicals Industry					
WR Grace	156	127	100	97	141
Comparable companies	84	91	100	89	74
Automotive Parts Industry					
Federal-Mogul	72	125	100	99	107
Comparable companies	104	107	100	83	72
Power Generation Industry					
Babcock & Wilcox	69	100	55	75	167
Comparable companies	238	100	48	105	81

(1) Armstrong filed for bankruptcy on December 6, 2000 and Owens Corning on October 5, 2000.
(2) Sole operating asset of G-I Holdings, which filed for bankruptcy on January 5, 2001; assumed here filed in 2000.

Figure 9. Aggregate Cash and Cash Equivalents for the Seven Largest Chapter 11 Companies with Asbestos Overhang



STUDY ENTITLED, "THE IMPACT OF ASBESTOS LIABILITIES ON WORKERS IN BANKRUPT FIRMS," SUBMITTED BY LESTER BRICKMAN

THE IMPACT OF ASBESTOS LIABILITIES ON WORKERS IN BANKRUPT FIRMS

JOSEPH E. STIGLITZ
JONATHAN M. ORSZAG
PETER R. ORSZAG

SEBAGO ASSOCIATES

COMMISSIONED BY THE AMERICAN INSURANCE ASSOCIATION
DECEMBER 2002

About This Study

This study was commissioned by the American Insurance Association as an independent analysis of the costs borne by workers of firms filing for bankruptcies due to asbestos liabilities.

The views and opinions expressed in this study are solely those of the authors and do not necessarily reflect the views and opinions of the American Insurance Association or any of the institutions with which the authors are associated.

The authors of the study are:

Joseph Stiglitz (stiglitzj@sbgo.com) is Professor of Economics at Columbia University, and Senior Director and Chairman of the Advisory Committee at Sebago Associates, Inc., an economic policy consulting firm. Dr. Stiglitz is the co-winner of the 2001 Nobel Prize in Economic Sciences. Previously, Dr. Stiglitz served as the World Bank's Chief Economist and Senior Vice President for Development Economics and, before that, as the Chairman of the President's Council of Economic Advisers.

Jonathan Orszag (jorszag@sbgo.com) is the Managing Director of Sebago Associates. Prior to joining Sebago Associates, Mr. Orszag served as the Assistant to the Secretary of Commerce and Director of the Office of Policy and Strategic Planning.

Peter Orszag (orszagp@sbgo.com) is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution and a Senior Director at Sebago Associates. Dr. Orszag previously served as Special Assistant to the President for Economic Policy at the White House.

The authors thank AES Consulting, Ginsberg Lahey, Alexandre Mas, and Ed Zyslik for excellent research assistance.

Executive Summary

Asbestos claims have skyrocketed over the past decade. These claims are pushing many companies into bankruptcy or at least to the brink of filing for bankruptcy protection.

The pain and suffering of impaired asbestos claimants are palpable and undeniable. It is important to realize, however, that the current system of paying asbestos claims imposes significant costs not just on businesses, but on their individual employees. Wages, future employment prospects, and the ability to save for retirement are all affected. The purpose of this paper is not to suggest in any way that impaired claimants are unworthy of assistance, but rather to highlight the fact that payments to any claimants are not free and to illuminate some of the costs imposed on workers as a result.

We estimate that 61 companies have filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code as a result of asbestos liabilities. These companies are spread across the nation, with 47 states having at least one asbestos-related bankruptcy. Many of the workers at these companies – which employed 204,868 people the year before they filed for bankruptcy – are members of unions, and they are often shareholders in the companies as well as employees.

The bankruptcies associated with asbestos liabilities have had a marked deleterious effect on workers in those firms. For example, we found:

- Bankruptcies led to a loss of an estimated 52,000 to 60,000 jobs;
- Each displaced worker at the bankrupt firms will lose, on average, an estimated $25,000 to $50,000 in wages over his or her career because of periods of unemployment and the likelihood of having to take a new job paying a lower salary; and
- The average worker at an asbestos-related bankrupt firm with a 401(k) plan suffered roughly $8,300 in pension losses, which represented, on average, a roughly 25-percent reduction in the value of the 401(k) account.

The bankruptcy event itself is costly, since the legal, accounting, and other transaction costs associated with a bankruptcy can be significant. Based on the published literature on the topic, the direct costs of bankruptcy amount to between three and six percent of the firm's market capitalization. This range suggests that the direct costs associated with asbestos-related bankrupt companies total between $325 million and $650 million.

The pace at which these bankruptcies have been filed has accelerated in recent years: Since 1998, 35 companies have filed for bankruptcy protection because of asbestos-related claims, compared to 26 in the previous two decades. In the first ten months of 2002, 15 companies facing significant asbestos liabilities filed for bankruptcy – that represents more asbestos-related bankruptcies than in any five-year period before 1999.

This paper has focused primarily on the costs associated with firms declaring bankruptcy because of asbestos liabilities. While it is important to remember that such bankruptcies are unlikely to have substantial macroeconomic effects, it is also important to remember that the bankruptcies do not capture the full effect of asbestos liabilities on defendants. In particular, many other firms experience financial shocks as a result of asbestos liabilities even if they do not declare bankruptcy as a result. Furthermore, perhaps only a quarter of the estimated eventual costs associated with asbestos claims have been paid to date, raising the specter of many more companies facing severe financial effects and additional asbestos-related bankruptcies in the future. Any such additional bankruptcies are not reflected in our analysis.

Our conclusion is that the current system for handling asbestos claims imposes significant costs on the workers (and shareholders) of the defendant firms. Since many of these firms were not asbestos manufacturers, the costs imposed on workers may seem unfair and inefficient from an economic perspective.

I. Introduction

Prior to the 1970s, asbestos was an important and cost-effective input in a wide variety of manufactured products, from wire insulation to building materials. Asbestos had unique and attractive features: It was cheap, strong, flexible, and resistant to heat and decay. Reflecting these advantages, it was promulgated as a "strategic material" during World War II.[1] Throughout much of the 20th century, asbestos was widely used and an estimated 100 million Americans were occupationally exposed to it.[2]

In the early 1970s, the United States government – through the Occupational Safety and Health Administration (OSHA) within the Department of Labor – began regulating workplace exposure to asbestos. Over time, the regulations became increasingly stringent. Asbestos use remains technically legal in the United States today, but OSHA and Environmental Protection Agency (EPA) regulations have effectively phased out most uses of asbestos.

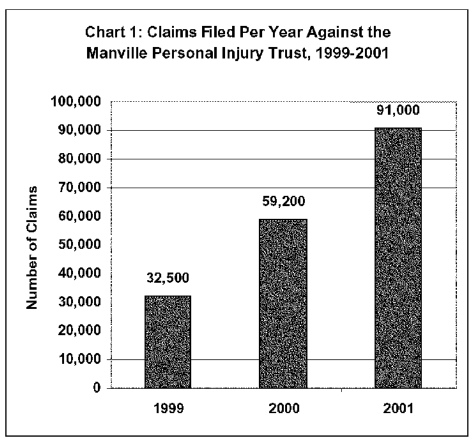
A number of diseases have been linked to asbestos exposure. The most severe is mesothelioma, a cancer that is fatal within one to two years of diagnosis. The inhalation of asbestos also can cause lung and other cancers. A third disease arising from exposure to asbestos dust is asbestosis, which is a fibrous scarring of the lung that may or may not impair an individual. A fourth condition associated with asbestos exposure is pleural plaques, which are generally non-impairing symptomatic changes in the pleural membrane covering the lung.

Prior to the 1970s, workers with an asbestos-related disease generally filed for relief through state worker's compensation systems. In 1973, the U.S. Court of Appeals for the Fifth Circuit ruled in *Borel v. Fibreboard* that manufacturers were liable if they failed to warn consumers about the risks associated with asbestos exposure.[3]

---

[1] See American Academy of Actuaries (2001), page 1.
[2] Ibid.
[3] See *Borel v. Fibreboard Corp.*, 493 F.2d 1076 (5th Cir. 1973). For a more detailed discussion of the history of asbestos litigation, see Castleman (1996).

Given the long latency period of asbestos-related diseases (up to 40 years), many experts had expected the filing of claims to peak in the 1980s or early 1990s.[4] Asbestos claims, however, continued to skyrocket in the 1990s.[5] A RAND Institute for Civil Justice (RAND) analysis of five major asbestos defendants suggests, for example, that each company was receiving roughly 15,000 to 20,000 claims per year in the early 1990s. By 2000, that number had increased to roughly 50,000 claims per year.[6] Similarly, the Manville Trust – which pays asbestos claims for former asbestos producer Johns-Manville – has experienced substantial increases in claims in the past few years. In 1999, the Manville Trust had 32,500 new claims filed against it. New claims rose to approximately 59,200 in 2000 and 91,000 in 2001.[7] (See Chart 1.)



[4] Castleman, page 784.
[5] There are myriad reasons why the number of claims has increased so sharply. See White (2002), Plevin and Kalish (2001), and Prudential (2002) for a discussion of the reasons.
[6] Stephen Carroll et al. (2002), page 42.
[7] See http://www.mantrust.org

The claims are also increasingly being extended to a wider array of firms. In 1983, RAND found 300 firms had been listed as defendants in asbestos cases.[8] By 2002, RAND estimates that more than 6,000 independent entities have been named as asbestos-liability defendants.[9] The dramatic recent expansion in defendants raises an important public policy issue. One of the objectives of product liability law is to provide financial incentives for manufacturers to ensure the safety of their products. When joint and several liability is extended well beyond the original manufacturer to include an extremely broad class of firms, however, it could impose an inefficient burden.[10] As explained below, joint and several liability means that any firm in the production chain could potentially be held accountable for the entire cost of the damage associated with an input. To reduce the expected costs of such liabilities, the downstream firms may have to undertake excessive safety checks on all the inputs used in their production processes. The information costs associated with this activity may well outweigh the benefits associated with improved incentives for safety.

The incentive effects discussed above relate primarily to the expected cost of the liability facing specific firms. A distinct issue involves the distribution of any liability payments actually made to claimants. According to the RAND, at least 600,000 individuals filed asbestos-related claims between 1973 and the end of 2000, many against multiple companies.[11] This figure may be an underestimate of the total number of individuals filing claims since RAND's database is incomplete: it only has data on claims filed against certain companies, not every company with an asbestos claim against it. In addition, RAND notes that it only obtained data on claims submitted through the end of 2000; as shown above, however, a significant number of individuals filed claims in 2001.

[8] Stephen Carroll et al. (2002), page 49.
[9] Ibid.
[10] The long latency period involved in cases such as asbestos raises another potential impediment to the effectiveness of the liability system in providing incentives for the safety of products. If a firm's managers and owners will have departed by the time any safety problems or illnesses manifest themselves, the incentives provided for corrective action may be weakened.
[11] Stephen Carroll et al. (2002), page 40.

Nonetheless, other organizations have produced estimates that are similar to RAND's calculations.[12]

The dramatic acceleration in claims does not appear to be associated with an acceleration in the number of severely affected people... about 2,000 new mesothelioma cases are filed each year, a flow which is largely unchanged over the past decade

The dramatic acceleration in claims does *not* appear to be associated with an acceleration in the number of severely affected people. Indeed, the American Academy of Actuaries has concluded that about 2,000 new mesothelioma cases are filed each year, a flow which is largely unchanged over the past decade, and that the annual number of other cancer cases at least partly related to asbestos exposure amounts to between 2,000 and 3,000.[13] Such cases cannot come close to explaining the increase in asbestos claims being filed, which increased by almost 60,000 between 1999 and 2001.[14] RAND concluded that "it is clear that the growth in the annual number of claims observed…is entirely due to increases in the numbers of nonmalignant claims entering the system."[15]

The upshot is that the share of total new claimants who are unimpaired has increased sharply. In 1984, RAND estimated that fewer than four percent of claimants had no asbestos-related impairment.[16] A 1992 paper asserted that non-mesothelioma (and other cancer) claims "account[ed] for sixty to seventy percent of new asbestos claims filed."[17] In a 1993 paper, Professors Christopher Edley and Paul Weiler of Harvard Law School estimated that "up to one-half of asbestos claims are now being filed by people who have little or no physical impairment."[18]

More recent studies of have concluded that even a larger share of claimants is unimpaired. NERA, an economics consulting firm, found that roughly 75 percent of the

[12] For example, a 1999 National Judicial Conference report estimated that there were between 300,000 and 700,000 asbestos claimants.
[13] American Academy of Actuaries (2001), page 3.
[14] See www.mantrust.org
[15] Stephen Carroll et al. (2002), page 44.
[16] Kakalik et al. (1984), page 30.
[17] Brickman (1992).
[18] Edley and Weiler (1993).

claims brought against one defendant in 1999 and 2000 had no evidence of impairment.[19] Similarly, a preliminary analysis of claims filed against Babcock and Wilcox in 2001 concluded that "two-thirds of the claims... seek to recover for benign and harmless conditions such as pleural plaques, pleural thickening with no evidence of impaired lung function, or asbestosis with no evidence of impairment."[20] Data from claims against W.R. Grace produce similar results.[21]

The rapid increase in claims has, not surprisingly, been associated with an increase in total outlays. To date, RAND estimates that aggregate outlays for asbestos claims total $54 billion, with U.S. insurance companies covering an estimated $21.6 billion,[22] non-U.S. insurance companies covering $8 billion to $12 billion, and the defendant companies paying $20 billion to $24 billion, including at least five companies which have each spent more than $1 billion.[23]

Looking to the future, most analysts believe that the number of claimants and total outlays for claims will continue to rise. Tillinghast-Towers Perrin, an actuarial consulting firm, projects that 1.1 million claims will eventually be filed, with the total cost to defendants and insurers amounting to $200 billion.[24] Milliman USA, another actuarial consulting firm, also forecasts 1.1 million total cumulative claims, but it projects higher total costs ($275 billion).[25] These projections imply that only roughly half of the claims and one-fifth to one-quarter of the eventual costs have been paid to date.

---

[19] See National Economic Research Associates, Unimpaired Claims Analysis (February 26, 2001). Of all claims received by the Manville Trust in 1999 and 2000, 11 percent were malignant claims (4 percent mesothelioma, 6 percent lung cancer, and 1 percent other cancers), and 89 percent were non-malignant claims.

[20] See Babcox and Wilcox's Report to the Court Regarding Asbestos Developments Generally and the Proofs of Claim Filed Here, at 32-37, and Road Map to Babcox and Wilcox's Defenses to Asbestos Personal Injury Claims, VII-1&2, *In re The Babcock & Wilcox Co.*, Bcy No. 00-10992 (Bankr. E.D. La)(October 18, 2001).

[21] See Debtors' Consolidated Reply in Support of Their Motion For Entry of Case Management Order, etc., In re W.R. Grace Co., Bcy No. 01-01139 (D. Del.)(November 9, 2001).

[22] See A.M Best (2001).

[23] Stephen Carroll et al. (2002), pages 53-55.

[24] Lehman (2002), page 5.

The staggering costs of asbestos liabilities have pushed many defendant companies into bankruptcy or to the brink thereof

The staggering costs of asbestos liabilities have pushed many defendant companies into bankruptcy or to the brink thereof. We estimate that 61 companies have faced significant asbestos liabilities and have filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code as a result.[26] (Our selection methodology is described in more detail in the next section.)

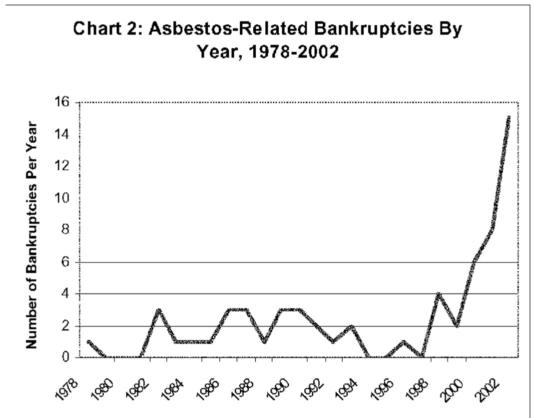
The pace at which these bankruptcies have been filed has accelerated in recent years: Since 1998, more companies have filed for bankruptcy protection (35 companies) than in the previous 20 years combined (26 companies). (See Chart 2.) In the first ten months of 2002, 15 companies facing significant asbestos liabilities filed for bankruptcy – that represents more asbestos-related bankruptcies in 10 months than in any five-year period before 1999.

Bankruptcy offers firms facing substantial asbestos liabilities a number of benefits.[27] First, bankruptcy includes an "automatic stay" on litigation in which the firm is the defendant. Second, the firm can often obtain an injunction, which temporarily protects the parent (as well as subsidiary firms that have not filed for bankruptcy) from asbestos liabilities. Since bankruptcy reorganization can often take more than five years, bankrupt firms often receive a relatively lengthy reprieve from paying asbestos liabilities. Moreover, as part of the reorganization plan, the bankrupt firm usually wins the right to pay claimants on much less favorable terms.

Another effect of a firm's declaring bankruptcy is that it may cause a "domino effect" on other asbestos-related defendants. The domino effect arises from three simple

[25] Ibid, page 22.
[26] For comparison, RAND estimates in their September 2002 study that 60 companies have been pushed into bankruptcy due to asbestos liabilities. See Stephen Carroll et al. (2002), page 75.
[27] The *Economist* recently noted that, "Bankruptcy may not sound like an attractive option, but it is often the best alternative for firms in the throes of asbestos litigation." *The Economist*, September 19, 2002.

facts: (1) many states have joint and several liability for damage; (2) most people sue multiple defendants;[28] and (3) most claimants "forum shop."[29]



An example may help to explain how this effect works.[30] Suppose that an individual (John Doe) sues two companies (Company A and Company B) because he has developed asbestosis and is physically impaired. Further suppose that John Doe proves to a jury that both Company A and Company B are jointly liable for his impaired condition and they owe him a total of \$500,000. If Company A goes bankrupt before it pays John Doe its share of the \$500,000 (say, \$250,000), Company B may be liable for Company A's share of the damages. Thus, if Company A files for bankruptcy, the asbestos-related costs for Company B increase. Such a structure creates a number of

[28] According to RAND, "In the early 1980s, claimants typically named about 20 different defendants. The data we have now suggests that by the mid-1990s, the typical claimant named 60 to 70 defendants." Stephen Carroll et al. (2002), page 41.
[29] A number of analysts have noted that a disproportionate percentage of the claims are filed in state courts that are considered to be "pro-plaintiff." For example, Mississippi has only one percent of the U.S. population, but accounts for roughly 20 percent of the pending claims. See American Academy of Actuaries (2001), page 3. *Fortune* magazine notes that in July 1999, "some 9,100 asbestos plaintiffs from all over the country were suing in rural Jefferson County, Miss.—about 700 more asbestos plaintiffs than there were county residents." See Parloff (2002). RAND has similarly found that five states account for two-thirds of recent cases filed, and 84 percent of all the claims were filed in just 10 states. See Stephen Carroll et al. (2002), pages 32 and 34.
[30] This example simplifies the joint and several liability rules, which vary across states.

perverse effects, including the incentive for firms to declare bankruptcy in order to shift liabilities to other firms (which in turn raises the probability that the other firms will be forced into bankruptcy) and the incentive for claimants to sue as many defendants as possible.

The events leading to the bankruptcy, along with the bankruptcy itself, also tend to be associated with a loss in human capital (for the workers displaced from their jobs) and organizational capital (if the firm is scaled back or no longer exists)

Although bankruptcy may provide benefits to firms facing significant asbestos liabilities, it also imposes economic costs. In particular, empirical studies have shown that bankruptcy is associated with significant transaction costs (for the lawyers, accountants, and others involved in the proceedings). The events leading to the bankruptcy, along with the bankruptcy event itself, also tend to be associated with a loss in human capital (for the workers displaced from their jobs) and organizational capital (if the firm is scaled back or no longer exists). As we discuss below, a significant share of these costs is borne by the firm's workers. In most cases, the workers would not have been in a position – nor perhaps even employed by the firm at the time – to alter the choice of input used in the production process. Having such workers bear a substantial share of the costs attenuates any positive incentive effects from the underlying product liability approach. In the absence of any significant incentive effects, the attractiveness of the product liability approach relative to alternatives for compensating victims is therefore weaker, since the product liability approach may involve higher transaction costs and be less fair than alternatives.

The purpose of this paper is to analyze the impact of asbestos-related bankruptcies on the workers of asbestos-related companies. The paper is divided into three sections. The first section explores the characteristics (such as size, location, and industry distribution) of the companies that have filed for bankruptcy due to asbestos-related claims. The second section focuses on the effects of asbestos liabilities on workers in the bankrupted firms, including the impact on employment levels and the effects on workers in their role as partial owners of the firm (especially through their pension plans). The final section draws conclusions from the previous sections.

II. Asbestos-Related Bankruptcies

This section provides a brief history of asbestos-related bankruptcies and examines the characteristics of the 61 bankrupt companies.[31] We compiled our list of bankrupt companies from five different sources: (1) a paper by Mark Plevin and Paul Kalish (*Where Are They Now? A History of the Companies That Have Sought Bankruptcy Protection Due to Asbestos Claims*), (2) the June 2002 Mealey's Asbestos Bankruptcy Report, (3) a March 2002 Lehman Brothers analysis (*Thinking About Asbestos*), (4) a December 2001 report of the American Academy of Actuaries (*Overview of Asbestos Issues and Trends*), and (5) a list of companies that have sought bankruptcy protection that was provided to us by the American Insurance Association. The entire universe of companies cited by these sources exceeded 70.

After compiling this list, three filters limited our sample to U.S. firms for which asbestos liabilities played a substantial role in causing the bankruptcy. First, we sought confirmation from a variety of contemporaneous sources (e.g., press releases, bankruptcy filings, newspaper stories, other regulatory filings, etc.) that asbestos liabilities played a *significant* role in the bankruptcy. To be sure, other factors may have contributed to the company filing for bankruptcy (e.g., foreign competition, financial mismanagement, etc.), but for the companies we designate as "asbestos-related bankruptcies," asbestos was identified as a significant contributing factor to the decision to enter into bankruptcy. Second, we excluded any non-U.S. corporations because of data limitations. Finally, to avoid double counting, we treated separate bankruptcies by subsidiaries of the same parent firm as one bankruptcy event. (For example, when UNR Industries filed for bankruptcy in 1982, ten related companies filed at the same time.)

A Brief History of Asbestos-Related Bankruptcies

Asbestos-related bankruptcies can be grouped into four waves. The "first wave" occurred between 1978 and 1985 when seven companies with significant asbestos liabilities filed for bankruptcy protection. For example, UNR Industries faced an estimated 17,000 asbestos claims and projected that it was going to face another 120,000 claims when it filed for bankruptcy in July 1982. Johns-Manville, still the largest employer to have declared bankruptcy because of asbestos claims, filed for bankruptcy the next month. The companies that comprised this "first wave" of bankruptcies were primarily large asbestos manufacturers.

The "second wave" of asbestos-related bankruptcies occurred between 1986 and 1993. During that time period, 18 companies entered into bankruptcy due to significant asbestos liabilities. Some of these companies were quite large: Todd Shipyards employed 4,400 workers in 1986, the year before it went bankrupt; and Hillsborough Holdings employed 8,935 workers in 1988, the year before it went bankrupt. None of these companies, however, approached the size of Johns-Manville, which employed 27,000 people in 1981.

From 1994 to 1997 ("the third wave"), there was a sharp downturn in asbestos-related bankruptcies. Only one company (Rock Wool Manufacturing) filed for Chapter 11 protection, although it was not a prominent asbestos-liability defendant.[32]

The "fourth wave" of asbestos-related bankruptcies started after the U.S. Supreme Court struck down *Georgine v. Amchem Products*, a landmark asbestos settlement, in June 1997. It accelerated after the U.S. Supreme Court overturned a 1993 global class action settlement, *Ortiz v. Fibreboard*, in June 1999. That settlement involved approximately 186,000 asbestos personal injury claims against the Fibreboard Corp., a

[31] Three companies in the sample filed for bankruptcy after September 2002. Since our analytical work had been completed by then, we included these companies in the overall count, but did not include them in our various analyses.

[32] See Plevin and Kalish (2001).

maker of vinyl siding that is now a subsidiary of Owens Corning. As one Chief Executive Officer confided to *Fortune* in March 2002, "We should've filed bankruptcy on the day after the Georgine settlement was overturned by the Supreme Court… Every asbestos defendant should've done the same thing."[33] In 1998, there were four asbestos-related bankruptcies. By 2001, there were eight, and in the first ten months of 2002, there were 15 asbestos-related bankruptcies. These companies employed more than 135,000 workers: for example, Owens Corning employed 20,000 and Babcox and Wilcox employed 12,264 people in 1999, the year before both firms declared bankruptcy.

Size of Asbestos-Related Bankrupt Firms

Using data from Compustat, Dun & Bradstreet's Million Dollar Directory, Ward's Business Directory, Moody's, company web sites, and individual firms' Securities and Exchange Commission (SEC) filings, we constructed an employment database for the asbestos-related bankrupt companies. Employment data were available for only 40 of the companies. The other 18 companies were small and presumably excluded from the above-mentioned data sources; as noted above, three companies were excluded because they filed for bankruptcy after our analysis was completed. For some companies – roughly 10 – we built a time series of employment data between 1960 and 2001. For the other 30 companies, employment data were available on an infrequent basis or for shorter time periods (e.g., for Kaiser Aluminum, data were available for 1986 to 2001).[34]

Table 2 presents data on the size of the firms that have filed for bankruptcy in each of the four waves described above. Since 1978, 26 companies facing asbestos liabilities filed for bankruptcy when they had more than 1,000 employees, with seven companies having more than 10,000 workers when they filed for bankruptcy protection.

[33] See Parloff (2002).

[34] Since employment data were often unavailable from the same data source for the whole time period, we often had to cross data series. Such a mixing of data series may introduce some biases in the employment numbers. If the data did not appear to match – that is, switching from one data source to another was associated with a significant increase or decrease in employment – we filtered the data from the database.

The companies that have filed bankruptcy most recently appear to be the largest firms, with six out of the seven largest filing for bankruptcy since 1998.

Table 2: Size of Asbestos-Related Bankrupt Companies, By Employment Level in Year Before Firm Entered into Bankruptcy, By Time Period					
	"First Wave": 1978-1985	**"Second Wave": 1986-1993**	**"Third Wave": 1994-1997**	**"Fourth Wave": 1998-2002**	**Total**
More than 10,000 Employees	1	0	0	6	**7**
Between 1,000 and 10,000 Employees	1	8	0	10	**19**
Fewer than 1,000 Employees	0	5	1	8	**14**
Data Not Available	5	5	0	8	**18**
Total	**7**	**18**	**1**	**32***	**58***

* Three companies were excluded because they filed for bankruptcy after September 2002, when our analysis was completed.

Table 3 offers another perspective on the size of the bankrupted firms in the past four years. In total, the 40 companies in our database employed 204,868 workers the year before they filed for bankruptcy.[35] Two-thirds (66.7 percent) of these employees worked at firms that went bankrupt in the past four years. That is, the companies that went bankrupt between 1998 and 2002 employed a total of 136,831 people in the year before each company filed for Chapter 11 protection.

[35] For some companies data were unavailable for the year prior to it filing for bankruptcy. In such cases, we used the closest year data were available, as long as it was not more than five years from the date in which the company filed for bankruptcy.

Table 3: Number of Asbestos-Related Bankruptcies and the Number of Workers Employed By the Firms, By Time Period		
Time Period	**Bankrupt Companies For Which We Have Employment Data**	**Number of Workers Employed By Bankrupt Firms Year Before Bankruptcy Filing**
"First Wave": 1978-1985	2	30,600
"Second Wave": 1986-1993	13	37,365
"Third Wave": 1994-1997	1	72
"Fourth Wave": 1998-2002	24	136,831
Total	**40**	**204,868**

Another measure of the size of the bankrupt companies is their market capitalization one year prior to filing bankruptcy. From the Center for Research in Security Prices (CRSP) market database and individual companies' Securities and Exchange Commission (SEC) filings, we obtained market capitalization data for 17 companies. (Many of the bankrupt companies were either privately held or were subsidiaries of larger firms. For such companies, market capitalization data are not publicly available.) Since companies filed for bankruptcy in different years, we converted each firm's market capitalization level into July 2002 dollars using the Consumer Price Index (CPI-U). As Table 4 shows, four of the 17 firms had market capitalizations of more than $1 billion the year before they filed for bankruptcy, two firms had market capitalizations of between $500 million and $1 billion, six firms had market capitalizations of between $100 million and $500 million, and five firms had market capitalizations of less than $100 million. All four firms with market capitalizations over $1 billion filed for bankruptcy after 1998.

Table 4: Market Capitalization of Bankrupt Firms One Year Prior to Filing for Bankruptcy, in July 2002 Dollars	
Market Capitalization (in July 2002 Dollars)	**Number of Firms**
More than $1 billion	4
$500 million to $1 billion	2
$100 million to $500 million	6
Less than $100 million	5
Total	**17**

Industry Distribution of Asbestos-Related Bankrupt Firms

A number of analysts have noted that the companies facing asbestos liabilities are not concentrated in a particular industry. For example, RAND has found that "The firms on our current list of defendants fall into 75 different SIC categories at the 2-digit level. The SIC system divides the entire U. S. economy into 82 industries at this level. In other words, this litigation has spread to touch firms in industries engaged in almost every form of economic activity that takes place in the American economy."[36]

Companies outside asbestos manufacturing appear to be paying a larger share of the asbestos liabilities today. Specifically, according to a confidential study of asbestos costs cited by RAND, nontraditional defendants accounted for about 60 percent of asbestos expenditures by the late 1990s. By comparison, in the early 1980s, the report cites evidence that nontraditional defendants accounted for only about one-quarter of asbestos-liability costs.[37] A different analysis by Prudential Financial draws a similar conclusion. Prudential Financial notes that as traditional defendants – those involved in the mining, manufacturing, and distribution of products that included large amounts of asbestos – declared bankruptcy, claimants cited other organizations as responsible parties. The study notes, "Defendants are increasingly 'peripheral.' This generally means that: They did not manufacture, sell, or install asbestos-containing insulation or materials; [a]sbestos was more or less 'incidental' in their products or facilities; [i]f it was in their products, it was enclosed [and] therefore, only a minimal number of fibers were released into the air; and [t]heir current outstanding claims count is in the hundreds or low thousands… opposed to the more than one hundred thousand recorded by the traditional defendants."[38]

Companies outside asbestos manufacturing appear to be paying a larger share of the asbestos liabilities today

[36] See Stephen Carroll et al. (2002), page 50.
[37] Ibid.
[38] Prudential Financial (2002), page 3.

The Prudential Financial report provides a list of nearly 1,000 organizations that are current defendants in asbestos litigation, along with an industry classification for each defendant. As noted above, RAND estimates that there are more than 6,000 defendants. The Prudential Financial list is thus a subset of all defendants and only 39 bankrupt companies are included. We have divided this incomplete list into bankrupt and non-bankrupt companies. (See Table 5.) The table shows clearly that defendants – and, to a lesser degree, bankrupt companies – are spread across different industry groups.

Table 5: Distribution of Defendants and Bankrupt Companies, By Industry Group, As Presented in Prudential Financial's *Asbestos Litigation—A Problem Without A Solution*

Industry	Defendants	Bankrupt Companies
Aluminum & Metal Plants[39]	30	1
Asbestos Industry[40]	128	16
Automotive	5	
Brake Product Manufacturers	11	
Cement Manufacturer[41]	23	1
Chemical Plant	28	
Commercial Industry Jobsites	19	4
Commercial Industry West Coast	8	1
Construction	3	
Contractor	16	
Distributor	14	
Diversified	1	
Financial Services	3	
Fireproofing Manufacturers	6	2
Floor Tile Manufacturers	1	1
Food	1	
Gasket & Packing Manufacturers	1	
Hotels	2	
Imaging	1	
Industrial Boiler Companies	2	1
Lumber Industry Mills	3	
Lumber, Plywood, Veneer/Particleboard	24	
Manufacturing	47	2
Marine	3	
Media	1	
Mills – Plants	3	
Miscellaneous	1	
Oil Refinery	91	

[39] Includes defendants categorized as "Aluminum Plant."
[40] Includes defendants categorized as "Sold, Made, Designed Asbestos Products."
[41] Includes "Insulating Cement Manufacturer" and "Refractory Cement Manufacturer."

Paper/Pulp Mills	27	
Pharmaceuticals	3	
Power Plants[42]	230	
Real Estate	1	
Refineries/Chemical Plants	35	
Shipyards[43]	116	2
Steel Mill	58	1
Supplier	2	
Technology	1	
Telecommunications	3	
Thermal Insulation Manufacturers	7	3
Transite Pipe Manufacturers	4	1
Transportation	9	1
Turbine Companies	1	
Utility	2	
Wallboard, Plaster & Joint Compound Manufacturers	17	2
Total	**992**	**39**

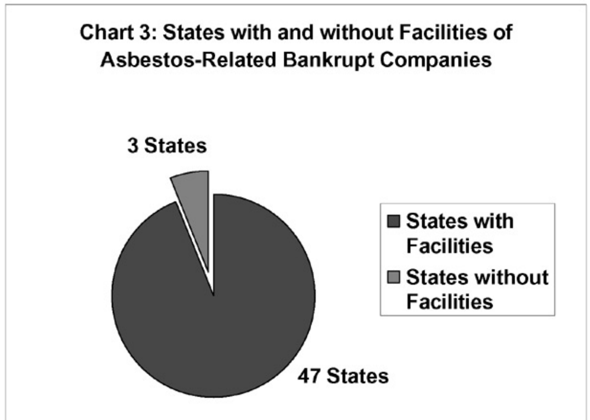
Location of Asbestos-Related Bankrupt Firms

Using the same sources described above to build our employment database, we also constructed a database on the locations within the United States of the companies that have sought bankruptcy protection due to asbestos liabilities. For 50 of the companies that have filed for bankruptcy before September 2002, we have data on the location of their headquarters. These companies are currently headquartered in 19 different states; Pennsylvania – which contains heavy concentrations of manufacturing firms -- accounts for almost a quarter of the bankrupted firms. See Table 6.

[42] Includes defendants categorized as "Industrial Sites – Power Plants," "West Coast Power Plant," "Power Plant," and "State & Electric Power Plants."
[43] Includes defendants categorized as "Shipyard."

Table 6: Distribution by State of Current Headquarters of Companies That Have Sought Bankruptcy Protection	
State	**Number of Companies Currently Headquartered in State**
Pennsylvania	12
Illinois	5
New Jersey	5
California	4
Maryland	3
New York	3
Alabama	2
Colorado	2
Florida	2
Michigan	2
Washington	2
Connecticut	1
Delaware	1
Idaho	1
Missouri	1
North Carolina	1
Ohio	1
Texas	1
Vermont	1

Our database also includes information on the location of company facilities. Many firms do not report the locations of all of their facilities, so this information is incomplete. In addition, our database does not include any information on the number of workers at a given facility. Despite these shortcomings, it is interesting that these 50 companies have facilities in 47 states. (See Chart 3.) The only states without a facility appear to be Hawaii, North Dakota, and Rhode Island.



Unionization of Asbestos-Related Bankrupt Firms

Although the bankrupt firms span a wide variety of industries, they are concentrated in manufacturing, which has a relatively high unionization rate. Many of the firms declaring bankruptcy report particularly high unionization rates in their SEC filings. For example, Johns-Manville reported that 42 percent of its workers were unionized in 1981, the year before it declared bankruptcy.[44] Other bankrupt firms report similarly high unionization rates for the year before they filed for bankruptcy: Eagle-Picher reported a unionization rate of 33 percent;[45] Federal Mogul reported 33 percent;[46] Armstrong reported 57 percent;[47] and Todd Shipyards reported 75 percent.[48]

[44] See Manville Corporation Annual Report (10-K) for the fiscal year ended December 31, 1981, page 11.
[45] According to Eagle-Picher, as of November 30, 1990, "approximately 33% of the Company's hourly employees were represented by eight labor organizations under 13 separate contracts." See Eagle-Picher Industries, Inc. Annual Report (10-K) for the fiscal year ended November 30, 1990, page 3.
[46] According to Federal Mogul, as of December 31, 2000, "Various unions represent[ed] approximately 33% of the Company's United States hourly employees." See Federal-Mogul Corporation Annual Report (10-K) for the fiscal year ended December 31, 2000, page 3.
[47] According to Armstrong, "About 57% of our approximately 12,400 hourly or salaried production and maintenance employees in the United States are represented by labor unions." See Armstrong World Industries Annual Report (10-K) for the fiscal year ended December 31, 1999, page 7.
[48] Todd Shipyards Annual Report (10-K) for the fiscal year ended March 30, 1986, page 9.

III. Economic Implications of Asbestos Liabilities and Bankruptcy

The previous section described the characteristics of the bankrupt companies that filed for bankruptcy prior to September 2002. This section explores the effect of asbestos-related liabilities and bankruptcies on employment, retirement security, government finances, and other economic factors. There is a large theoretical literature in economics, and a somewhat smaller empirical literature, on the effects of bankruptcies on firm financial policies and behavior.[49] Our focus here is more applied, and focuses specifically on asbestos-related bankruptcies.

Bankruptcies and the events that lead to them impose various forms of (potentially related) economic costs. First, the events leading to bankruptcy cause job displacement, which reduces the human capital of workers at the firm. These costs are borne primarily by the workers themselves (with some of the costs subsidized through the unemployment insurance system) but largely represent a loss to society as a whole. Second, bankruptcies can destroy the organizational capital associated with the firm; these costs are borne by both the workers and owners of the firm and also largely represent a loss to society as a whole. Third, the liability payments that caused the bankruptcy represent transfers from stockowners of the firm to victims; these transfers impose costs on the owners of the firm but produce benefits for the recipients. Only the net cost of the transfer – that is, any inefficiency associated with the transfer from one party to the other – represents a loss to society as a whole. Finally, the bankruptcy event itself involves direct transaction costs: the legal, accounting, and other costs associated with a bankruptcy can be significant. Our focus is primarily on the costs borne by workers at the bankrupt firms, through the loss of their human capital and the potential reduction in their retirement wealth (if they own shares of the firm through their retirement accounts), although we also discuss briefly the overall economic issues.

It is important to emphasize that some decline in the size, stock value, and employment of asbestos manufacturing firms is appropriate, given the discovery of the health risks associated with asbestos and the importance of the incentives provided by the liability system for improved safety. The purpose of this paper is not to separate the "appropriate" from the "inappropriate" costs associated with asbestos liabilities. Nonetheless, the mechanism used to transfer funds to victims is worthy of further examination. As discussed elsewhere in the paper, the increasingly extensive number of tangentially related defendants raises questions about the economic costs and benefits of the liability approach in this context.

Impact of Asbestos-Related Bankruptcy on Workers

As asbestos-related claims increase, firms may find it difficult to obtain new financing and retain clients. They may therefore seek to reduce costs, including labor costs, well before they actually declare bankruptcy.[50] In particular, as a firm approaches bankruptcy, it faces the challenge of maintaining its customer base and continuing production, which may make it difficult to maintain previous employment levels even before the bankruptcy occurs. Indeed, a common finding in the bankruptcy literature is that the threat of bankruptcy has real effects several years ahead of the bankruptcy event.[51]

The media have reported a large number of layoffs by firms declaring bankruptcy due to asbestos liabilities. For example, Federal-Mogul announced in January 2001 that it would close up to 50 of its 150 production units.[52] The following month (February 2001) it announced it was firing 1,100 workers.[53] This layoff followed an April 1998

[49] See, for example, Stiglitz (1972).
[50] The forgone profits and investment opportunities associated with this reduction in firm-level activity before and during the bankruptcy form the primary component of the indirect costs associated with bankruptcy. As discussed in the text below, these indirect costs are in addition to the direct costs – for lawyers, accountants, and others – required in the bankruptcy event itself.
[51] See, for example, Altman (1984).
[52] Jamie Butters, "Credit Gives Big Supplier A Life: Federal-Mogul Says Added $550 Million Assures Its Survival," *Detroit Free Press*, January 4, 2001.
[53] See Federal-Mogul Press Release, "Federal-Mogul Adjusts Salaried Workforce Levels to Reflect Business Conditions," February 26, 2001.

announcement by Federal-Mogul of 4,200 job cuts.[54] In 1998 and 1999, the years before it filed for bankruptcy, Owens Corning reported 1,500 layoffs.[55] And U.S. Gypsum announced in January 2001 that it would eliminate 500 salaried jobs as part of a restructuring plan.[56]

We conducted a more systematic and rigorous analysis of employment among asbestos-related bankrupt companies. We have time-series employment data for 31 of the companies that filed for bankruptcy prior to September 2002. The 31 firms for which we have time-series employment data represent the vast majority, and likely roughly 90 percent, of total employment for the bankrupt firms as a whole.[57] For these firms, we compared the change in employment of each firm in the five years prior to bankruptcy to the change in employment for other firms in the same four-digit Standard Industrial Classification (SIC) code.[58] The five-year period was chosen as a rough proxy for the time between the first material revelation of asbestos liabilities and the bankruptcy event. A longer-time period, such as ten years, produces an even larger employment effect than the estimate presented below.

Data for each four-digit SIC code were obtained from the Bureau of Labor Statistics; for each four-digit SIC code, we obtained an estimate for employment at the non-bankrupt firms by subtracting the employment at companies that declared

[54] See Federal-Mogul Press Release, "Federal-Mogul Announces First Quarter Results and Special Charges Related to Acquisitions and Restructuring," April 23, 1998.
[55] See Owens Corning 2000 SEC 10-K filing.
[56] James Miller, "USG's Asbestos Woes Bring $904 Million Charge," *Chicago Tribune*, January 12, 2001.
[57] We have some employment data for 40 firms and a fuller set of time-series data for 31 firms. The sample of 31 firms represents roughly 91 percent of employment at the 40 firms as a whole one year prior to bankruptcy. The 18 firms for which we have no employment data are extremely small, and are extremely likely to have had less than a total of 10,000 employees. The 31 firms in our sample would then represent 87 percent of total employment for the bankrupt firms as a whole.
[58] For 11 of the 31 companies, we did not have employment data for the precise year the firm declared bankruptcy or five years prior to the bankruptcy filing. For example, eight of these 11 companies filed for bankruptcy in 2001 or 2002, but employment data were available only through 2000 or 2001. For such companies, we analyzed the 1995-2000 or 1996-2001 time periods. The SIC system has recently been replaced by the North American Industry Classification System (NAICS).

bankruptcy due to asbestos liabilities from the overall SIC employment level.[59] The results of this analysis are summarized in Table 7.

After adjusting for the changes in industry employment, the 31 firms lost 51,970 jobs in the five years prior to bankruptcy. (The raw change in employment – that is, the change without adjusting for employment changes at the industry level – was a loss of 60,636 jobs.) Nine firms showed gains in employment in the five years prior to bankruptcy, while 22 firms experienced declines in employment. The change in employment represents an average 22-percent decline – relative to changes in industry employment – for the 31 bankrupt companies. And, as the table shows, roughly half (53 percent) of the change in employment has occurred in firms that have filed for bankruptcy since January 1998.

The 31 firms for which we have data likely represented 87 percent of total employment at the bankrupted firms as a whole. Assuming that employment losses at the firms for which we lack data were proportionate to those for which we have data, the implied total employment loss for the bankrupted firms as a whole would be roughly 60,000.

Table 7: Change in Employment in Five Years Prior To Bankruptcy After Controlling for Changes in Industry Employment

	Number of Lost Jobs
Firms Filing for Bankruptcy Before January 1998	24,551
Firms Filing for Bankruptcy After January 1998	27,419
Total for Firms With Data	**51,970**
Estimated Scaled Total for All Bankrupt Firms	**~60,000**

[59] If employment data were unavailable for the four-digit SIC code, we used the three-digit SIC code. If data for the three-digit SIC code were unavailable, we used data for the two-digit SIC code. In cases in which the firm's employment level represented a significant portion (more than one-third) of the total employment in the industry code, we also used more disaggregated data.

This methodology effectively assumes that, in the absence of the bankruptcy, the bankrupted firm would have maintained a constant share of the industry's employment. An alternative methodology, which has been applied to revenue calculations in other bankruptcy studies, most notably Altman (1984), uses regression analysis to examine the relationship between the firm's employment and industry employment for some period before the bankruptcy. It then applies that relationship to industry employment immediately surrounding the firm's bankruptcy to obtain a predicted level of employment. The difference between the predicted level of employment for the firm and the actual level is then attributed to bankruptcy-related events. We also conducted this type of analysis. The overall results were not qualitatively different from those summarized above when the requisite data were available, although the results for individual firms did vary in some cases. Because of data limitations, we prefer the principal approach adopted above rather than this regression-based approach.

RAND has also estimated job losses associated with asbestos-related bankruptcies or liabilities. Specifically, it bases its calculations for changes in employment levels on the amount defendant firms have paid out ($23 billion). RAND estimates that a reduction of $23 billion in retained earnings would result in a reduction in investment levels by the defendant firms of up to $10 billion. RAND then estimates the employment effect of this reduced investment. The study concludes that, "If, on average, one less job is created each time a firm reduces its investment levels by $78,000, the number of jobs not created because asbestos defendants spent $10 billion less on investment up to the year 2000 would be approximately 128,000."[60] RAND notes that these figures represent upper-bound estimates, since non-defendant firms will likely "make up" for the reduction in investment by defendant firms. Note that we focus only on bankrupt companies; RAND examined all defendant firms regardless of whether they declared bankruptcy.

Regardless of the precise estimate attached to employment losses associated with asbestos, it is important to emphasize that the aggregate level of employment in the nation as a whole will be primarily determined by factors other than asbestos liabilities

[60] Stephen Carroll et al. (2002), page 74.

and the bankruptcies that have resulted. That is, while the firms that have declared bankruptcy due to asbestos liabilities have reduced employment by between 52,000 and 60,000, the effects on total employment are likely to be smaller.

The workers displaced from the bankrupted firms may ultimately find employment elsewhere, but the transition could be costly and lengthy

The workers displaced from the bankrupted firms may ultimately find employment elsewhere, but the transition could be costly and lengthy. For example, regional imbalances in employment may make it difficult for workers to find a new job that matches their existing skills within driving distance of their existing home. And it is costly for workers to move or learn new skills. Research by Henry Farber, an economist at Princeton University, has shown that "the costs of job loss are substantial. Employment probabilities are reduced substantially. There is an increased probability of working part-time, yielding lower earnings both through shorter hours and lower wage rates. These costs are larger for those workers with less education. And even those re-employed full-time suffer substantial earnings losses on average, regardless of education level."[61]

The economic costs resulting from the dislocation involve two components:

- First, the structural and frictional unemployment associated with the bankruptcies represents a lost opportunity. That is, to the extent that the movement of the displaced workers to new jobs produces a temporary increase in the unemployment rate that would not have otherwise occurred, the production of goods and services lost during the transition represents a true economic cost. Data from the Bureau of Labor Statistics suggest that the median displaced worker who had been previously employed for at least three years and who finds a new job went approximately six weeks between jobs.[62] Furthermore, only about four-fifths of displaced workers were re-employed within a few years of being

[61] Farber (2001), page 31.
[62] BLS (2001).

displaced.[63] To give a conservative estimate of the magnitude of costs involved, we can adopt a variety of simplifying, but nonetheless reasonable, assumptions. If we assume an average displacement lasts for one month, that the displaced workers had earned an average of \$40,000 per year (which we also assume to be equal to the value of goods and services they produced), and that a total of 52,000 to 60,000 workers were displaced due to the asbestos-related bankruptcies, the unemployment spells associated with the displacements would represent an economic cost of about \$175 million to \$200 million.

- Second, displaced workers tend to earn lower wages at their new jobs, reflecting the loss of human capital associated with the displacement. Farber (2001) estimates that the loss in earnings from displacement amounts to between 5 and 10 percent of previous wages. Under the same assumptions as above, and assuming that the average displaced worker is 45, and has 20 years to retirement, the present value of the losses in wage income would amount to between \$1.2 billion and \$2.8 billion at a five percent real discount rate.

The total economic costs associated with the displacements under these assumptions would then amount to between \$1.4 billion and \$3.0 billion.

In addition to these earnings-related costs imposed on workers, bankruptcy also imposes costs on workers as shareholders. Many workers hold shares of the firm in their pension plans, so that workers suffer two forms of losses: a loss in their human capital (from their displaced employment) and a loss in their financial capital (from the decline in their retirement assets). In the next sub-section, we turn to estimates of the retirement asset losses experienced by workers in the bankrupt firms.

---

[63] Helwig (2001).

Impact of Asbestos-Related Bankruptcy on Retirement Security

Layoffs may not be the only costs to workers from asbestos-related bankruptcies. Indeed, current (and former) workers may experience significant deteriorations in retirement savings if their pension account is invested in company stock. As Michael Kavanagh, the president of a local union that represents 400 W.R. Grace employees in Baltimore, recently told the *Baltimore Sun*, he is "worried about retirees and those about to retire who were counting on the Grace stock they'd built up over the years to help supplement their post-paycheck years."[64]

This concern arises because as asbestos liabilities increase, the market value of the firm usually declines. Such stock market declines manifest themselves in decreased values of employee defined contribution (DC) pension plans, such as 401(k)s. In 1998, 40 percent of families had a 401(k) or other similar DC pension plan through their employer.[65] And as various policy-makers have emphasized in recent months, a significant portion of these DC pension plans are invested in the company's stock: According to the Employee Benefit Research Institute, roughly one-fifth (19 percent) of 401(k) assets are in company stock.[66] In total, the National Center for Employee Ownership estimates that approximately 25 to 30 million U.S. employees own stock in their companies through employee stock ownership plans (ESOPs), broad-based stock option plans, and DC plans.[67]

To estimate the impact of asbestos-related bankruptcies on employee retirement assets, we undertook two different approaches.

[64] Kristine Henry, "Old W.R. Grace v. New," *The Baltimore Sun*, July 1, 2001.
[65] Sunden and Surette (2000), Table 1, Page 2.
[66] Dallas Salisbury, Testimony Before the Senate Committee on Health, Education, Labor, and Pensions, February 7, 2002. Also see Munnell and Sunden (2002).
[67] See www.nceo.org

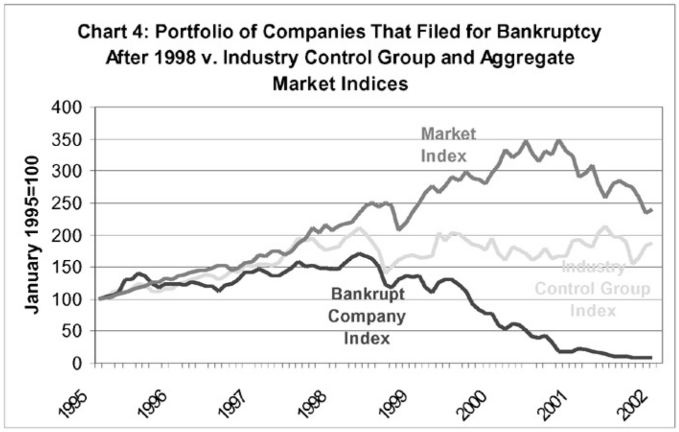
Changes in Stock Prices

The first method uses an estimate of the change in the stock price due to asbestos liabilities to calculate the change in retirement assets for each worker.

Of the companies that went bankrupt due to asbestos liabilities prior to September 2002, we have consistent time-series stock market data for 13 of them. As with the analyses of changes in employment, we compare stock market performance to a control group. In particular, we track the stock market price of each company for the five years before and, if possible, five years after bankruptcy to the performance of a control group of companies, weighted by market capitalization, that produce similar products and face similar economic and market circumstances. (Control group companies are those in the same three-digit SIC code as the bankrupt company, but have not filed for Chapter 11 protection for asbestos-related reasons.) Data on stock prices were obtained from the CRSP database; stock price data were adjusted to take into account dividend payments.

We limit the analysis to a ten-year period that begins five years prior to Chapter 11 filing and extends up to five years after the filing; the comparison stops before five years if the company liquidated, was acquired, or if the bankruptcy took place within the last five years. As before, we compare a market capitalization index for each bankrupt firm to a value-weighted market capitalization index for a control group of companies drawn from the same SIC. The index is normalized to 100 in January 1995 – the first period of comparison.

The results of this exercise for firms declaring bankruptcy after 1997 are shown in Chart 4. To simplify the presentation, aggregate indexes of the bankrupt firms and non-bankrupt firms within the same industries were constructed. As the graph shows, the bankrupt firms experienced significant stock market declines relative to their industry groups: while the industry control group increased 87 percent between 1995 and 2002, the bankrupt firm index fell 92 percent.



An analysis of the firm-by-firm results for all 13 companies for which we have full data shows that *all* these bankrupt firms underperform relative to their industry control group. This type of stock market underperformance is perhaps not surprising and has been found in other broader studies of bankruptcies.[68] The next step involves converting these results into an estimate of the impact on pension assets. Of the 13 companies analyzed, six report information on what share of employee pension assets are invested in common stock. We used information from the firm's SEC filings to estimate the per plan participant assets held in company stock.[69] Among the six firms, the average plan participant had 401(k) assets of $35,891, with $9,098 invested in company stock five

[68] See, for example, Altman (1984).

[69] We obtained SEC filings for 16 of the bankrupt companies. We first excluded three companies with ownership changes. Of the remaining 13 companies, eight reported defined contribution plans. Two of these companies were excluded because data were not available for the period within two years of bankruptcy. Of the remaining six companies, we computed the net common stock fund value per plan participant. In cases in which the companies offered multiple plans to various classes of employees, we consolidated the funds and participant figures. For one company (Federal Mogul), data on the number of plan participants were unavailable; we assumed that two-thirds of the employees were participants in the DC plan. Where a common stock fund's asset and liability breakdowns were not given, we used the fair market value of the common stocks held by the plan. For two companies, we were unable to obtain data for five years prior to bankruptcy. For both companies (Federal Mogul and Eagle Picher), we used data from three years prior to bankruptcy.

years before the company filed for bankruptcy.[70] Common stock thus represented 25 percent of the pension assets five years before the firms filed for bankruptcy; by comparison – as noted above – the national average is 19 percent.

If the investment in company stock had followed the industry control group index for these firms, the employee's pension assets would have dropped from $9,098 to $8,662. Instead, they declined by 96 percent. That is, on average, instead of the value of company stock falling to $8,662, it fell to $401 – a loss of $8,261 in pension wealth per affected worker relative to the level that would have obtained if the stock performed in line with the rest of the relevant industry control group. The total defined contribution pension losses amounted to more than $350 million.

<u>Changes in Per Plan Participant Assets</u>

The second methodology utilizes information supplied to the SEC by the companies in annual filings. Specifically, in 11-K filings, publicly traded companies report the share of the firm's pension fund assets that are held in company stock. We can thus calculate the assets that each plan participant holds in company stock by dividing that amount by the total number of plan participants.

We examine the per plan participant assets invested in company stock for five years before (or the closest time period to five years before) the company filed for bankruptcy and for the year the company filed for bankruptcy.[71]

This approach does not directly rely on an estimated change in the stock price, as the first approach does. But like the first approach, it implicitly assumes that the decline in plan assets is due to the bankruptcy itself rather than other factors. In addition, this approach has three shortcomings not relevant to the first approach. First, it likely obscures the underlying trend in per plan participant assets, since participants continue to contribute to the pension plan in the intervening period. Second, it does not control for

[70] These figures represent the average of the six firms, weighted by the number of plan participants.

changes at the industry level. In other words, it does not make even a crude adjustment for the change in per plan participant assets that would have occurred in the absence of the asbestos liabilities (e.g., the industry may have suffered a severe downturn that would have affected the per plan participant assets regardless of the asbestos liabilities). Finally, the per plan participant metric can be affected by hiring decisions and pension participation rates, since the addition of new plan participants with below-average balances would cause a decline in the per plan participant measure.

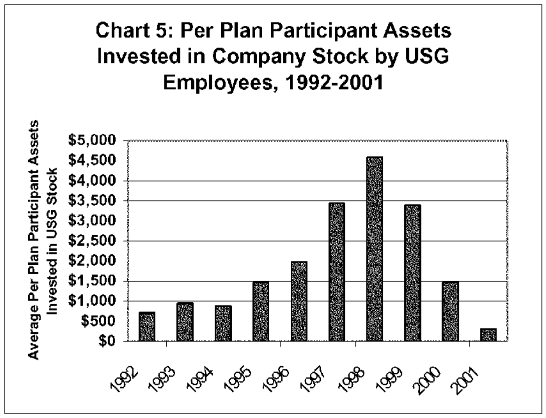
As noted above, we have data on pension fund investments in company stock for six firms. As Table 8 indicates, the weighted average per plan participant assets in the six companies for which we have data fell by $8,307 from the five years prior to bankruptcy to the year of bankruptcy.

Table 8: Change in Average Per Plan Participant Assets in Company Stock for Six Asbestos-Related Bankrupt Firms

	Average Per Plan Participant Assets
Five Years Before Bankruptcy	$9,098
Year of Bankruptcy	$791
Change	**$8,307**

As one example, Chart 5 shows the change in the per plan participant assets invested in company stock for USG employees. Between December 1996 and December 2001, per plan participant assets fell by $1,670, from $1,976 in December 1996 to $305 in December 2001. In December 1996, the pension fund held nearly $20 million in company stock; by December 2001, it held just $3.7 million. After accounting for inflows of pension savings, the USG pension fund lost more than $40 million between December 1998 and December 2001 due to the drop in USG's stock.

[71] For two of the six companies, data were only available for three years before bankruptcy.



Changes in Retirement Security

We can apply the results from the two methodologies above to estimate the impact on workers (and their families) from the loss of pension wealth. Such a reduction in pension wealth imposes a cost that could manifest itself in one of three ways: a reduction in consumption during retirement; an increase in savings (and thus a decrease in consumption) before retirement; or a delay in retirement.[72] To provide insight into the potential magnitude of these adjustments, we built a model of retirement saving.

The model takes a given level of current pension wealth, projects it forward to an assumed retirement age, and then annuitizes it (that is, converts the accumulated pension account into a monthly payment that is paid as long as the annuitant or his or her spouse is alive). The model takes into account the current age of the worker, the marital status of the worker, the worker's marginal tax rate in retirement (to examine after-tax retirement income), the worker's current 401(k) balance; the worker's current earnings; the worker's anticipated retirement age; an assumed real return on the 401(k) assets; an

[72] It could also manifest itself as a reduction in the worker's bequests to his or her children. For simplicity, we ignore this possibility.

assumed rate of aggregate real wage growth, combined with the age-wage profile constructed by the Office of the Chief Actuary at the Social Security Administration; and marital-specific annuitization rates. By comparing the results before and after the decline in pension wealth, the model can then be used to examine the effects of the decline on after-tax retirement income if no changes are made to saving or the worker's retirement age; required saving prior to retirement to maintain the previous level of after-tax retirement income; and the delay in the retirement age necessary to maintain a given level of after-tax retirement income without an increase in saving.

The projections shown in the table below assume actuarially fair annuities; a 5 percent real pre-tax return on assets; 1.5 percent aggregate real wage growth; a 25 percent marginal tax rate in retirement; that the worker is currently earning an age-adjusted lifetime equivalent of $45,000 per year; that the worker is married; and the worker intends to retire at age 65. We examine three workers: a 35-year-old, 45-year-old, and 55-year-old. Unfortunately, we do not have data on plan assets by age of worker. Therefore, for each worker, we assume 401(k) balances were initially equal to mean per plan assets for the affected companies ($35,891) multiplied by an age-related scaling factor. The age-related scaling factor was derived by comparing median financial assets by age groups from the Federal Reserve's Survey of Consumer Finances, and assuming that the median worker was 45 years old. The result was an assumed initial 401(k) balance of $14,795 for the 35-year-old worker; $35,891 for the 45-year-old worker; and $43,898 for the 55-year-old worker. In each case, we assumed a decline due to the bankruptcy of 25 percent, which is roughly consistent with the observed declines in plan assets (as discussed above).

As Table 9 shows, the losses imposed by bankruptcy cause substantial, albeit perhaps not devastating, costs on workers. For example, if a 45-year-old worker lost 25 percent of his assumed 401(k) balance, he could either allow his retirement income to fall by $1,250 per year or he could raise his annual 401(k) saving before retirement by $720 per year. For older workers, several offsetting forces affect the results. The first factor is that the accumulated 401(k) balances prior to the decline are assumed to be larger for the

55-year-old than for the 45-year-old, meaning that a given percentage decline represents a larger absolute loss at the time for the older worker. On the other hand, the power of compound interest means that a loss of $1 to a 45-year-old corresponds to a larger loss in retirement income than the loss of $1 to a 55-year-old. For example, $1 today would accumulate to $2.65 over the twenty years that a 45-year-old has until retirement; $1 today would accumulate only to $1.63 over the ten years that a 55-year-old has until retirement. Therefore, although the 55-year-old may lose more dollars today, the 45-year-old suffers more from the lost power of compound interest. Finally, the 55-year-old has fewer working years over which to make up the loss through additional contributions to the 401(k) plan.

Table 9: Impact of Loss of Pension Wealth on Measures of Retirement Security

	35-year old worker	45-year old worker	55-year old worker
	Assuming 25 percent decline in 401(k)		
Increase in required 401(k) saving per year to maintain pre-reduction retirement income ($2002)	$241	$720	$1,421
Reduction in retirement assets ($2002)	$15,986	$23,807	$17,876
Reduction in annual after-tax retirement income ($2002)	$839	$1,250	$939
Delay in retirement age to maintain pre-reduction retirement income per year (years)	0.48	0.83	0.72

Note: See text for assumptions.

Other Pension Losses Due to Asbestos-Related Bankruptcies

Bankruptcies can also impose large costs on defined benefit (DB) pension plans in addition to defined contribution plans. The Federal Government plays a significant role in protecting employees and retirees who participate in traditional (defined benefit) pension plans. A key element of that protection is the benefit guarantee for underfunded, terminating defined benefit plans that is administered by the Pension Benefit Guaranty

Corporation (PBGC), a government corporation established within the Department of Labor.[73] (Since the PBGC is required to be self-financing, it does not impose any direct cost on the Federal Government or on the taxpayers when it assumes trusteeship of a particular plan and thereby takes on additional liabilities to pay claims.) One example of a defined benefit plan that the government "took over" was the Atlas Corporation's 1978 Retirement Plan, which covered 148 workers. Atlas filed for bankruptcy in September 1998. On October 27, 1999, Atlas' DB plan was terminated and the PBBC became the trustee on November 18, 1999.[74] PBGC also took action against Raymark Industries. (Raymark created Raytech Corporation, which filed for bankruptcy in 1989.) In 1999, PBGC won a decision against Raymark. In the case, PBGC sought to ensure that Raymark covered the $19 million in pension liabilities owed to 1,500 former workers based in Connecticut, Pennsylvania, Indiana, South Carolina, and North Carolina.[75]

Losses associated with the declines in firm values (embodied in both stock value drops and corporate debt restructurings) are not, of course, concentrated solely among the employees and pension plans of the bankrupted firm. Instead, all shareholders and creditors bear some of the burden. For example, soon after USG Corporation entered into bankruptcy, the New York State Teachers Retirement Board ranked as the twelfth largest institutional investor in USG Corporation with nearly 400,000 shares.[76] The California Public Employees Retirement System (CALPERS) is currently the eighth largest institutional investor in W.R. Grace, which filed for bankruptcy in April of 2001.[77] And CALPERS and TIAA-CREF are two of the top ten institutional investors in Kaiser Aluminum.[78]

The sharp declines in the stock market value of asbestos-related bankrupt companies would thus likely have broader effects. One example of such a loss is the

---

[73] See, for example, Title IV of the Employee Retirement Income Security Act of 1974, as amended (ERISA), 29 USC section 1301 et seq.
[74] See http://www.pbgc.gov/plans/Planlookup.cfm?plan=2814
[75] See http://www.pbgc.gov/news/press_releases/1999/pr00010.htm
[76] In December 2001, the New York State Teachers Retirement Board owned 0.91 percent of USG Corporation. See http://www.marketguide.com
[77] See http://biz.yahoo.com/hd/g/gra.html
[78] See http://biz.yahoo.com/hd/k/klucq.ob.html

New York State Teachers Retirement Board's experience with Owens Corning. On March 31, 1999, the Board owned 449,200 shares of Owens Corning. While these shares represented a very small share – roughly 0.03 percent – of the entire pension fund, the value of the stock declined by roughly one third between March 31, 1999 and September 30, 1999. Owens Corning stock price continued to slide as it approached bankruptcy: It fell from 21.69 on September 30, 1999 to 1.19 on October 20, 2000 – a 95 percent decline in 13 months. If the New York Teachers Retirement Board had not sold any shares before Owens Corning filed for bankruptcy in October 2000, the pension fund would have lost nearly $14 million.

It is possible that the stock prices for other, non-defendant firms are indirectly bolstered by the asbestos liabilities – for example, successful claimants likely spend at least part of their awards on something, and the firms selling those goods and services could experience increases in their stock prices. But any such effects are almost impossible to quantify precisely – and given the transaction costs associated with the process, the overall effect on share values is very likely to be negative.

The Direct Costs of Asbestos-Related Bankruptcies

The estimates above are proxies for what are called the "indirect costs" of bankruptcy (Altman 1984). But the bankruptcy event itself involves direct transaction costs: the legal, accounting, and other costs associated with a bankruptcy can be significant.

Altman (1984) finds that the direct bankruptcy costs amount to 6.2 percent of a firm's value during the year of bankruptcy. RAND cites evidence that the cost of bankruptcy reorganization is equal to about three percent of a firm's value, based on Franks and Touros (1989); Weiss (1990); and White (1996). The RAND figure, however, values the firm's debt at book value rather than market value; Altman, where possible, uses market value instead.

To date, no one has studied the direct costs of asbestos bankruptcy reorganization. The bankruptcies that have been studied in the literature involved large publicly traded corporations comparable in size to large asbestos defendant corporations. But reorganization costs for asbestos defendants may be higher than figures reported in these earlier studies because none of the studied bankruptcies included massive numbers of tort creditors.

Based on the earlier literature, a conservative estimate is that the direct costs of bankruptcy amount to between 3 and 6 percent of the firm's market capitalization. Since the aggregate market capitalization one year prior to bankruptcy (in July 2002 dollars) for the 12 companies for which we have data was $7.2 billion, the direct costs associated with these asbestos-related bankrupt companies will total between $225 million and $425 million. These 12 firms represented about two-thirds of employment at the bankrupted firms as a whole; if the ratio of market capitalization to employment were the same for the other bankrupted firms as for these 12 firms, the total direct costs would amount to between $325 million and $650 million.

The previous studies had included some measure of corporate debt in computing the relative direct costs of bankruptcy; by excluding the debt altogether while nonetheless adopting the range of relative cost estimates from the previous studies, we obtain a conservative estimate for the dollar value of the direct costs. If we include the book value of the debt (nearly $12 billion) for the 12 companies for which we have data, the direct costs would range from $575 million to $1.1 billion. If we assume that the debt-worker ratio were the same at the firms for which we lack financial data, the total direct costs would amount to between $850 million and $1.7 billion.

Impact of Asbestos-Related Bankruptcy on Government Finances

The layoffs and stock market price declines associated with asbestos liabilities may have a variety of effects on government finances. For example, workers laid off from the firms facing asbestos claims may qualify for unemployment insurance and retraining programs. They may also become eligible for other means-tested benefits (including Food Stamps and Medicaid), depending on their family status, assets, and income while unemployed. In addition, the loss in wage income among the laid-off workers reduces both payroll taxes and income taxes, and the decline in stock prices for the bankrupted firms reduces capital gains if the stocks are held in taxable accounts (and ultimately reduces income taxes if the stocks are held in traditional retirement accounts). The loss in corporate profits at the firms involved reduces corporate profits tax revenue. But just as the employment losses at the affected firms will eventually be balanced by employment gains elsewhere in the economy as employment shifts to new jobs, the aggregate effect on government expenditures and revenue is less deleterious than this partial equilibrium picture may suggest.

Costs Imposed on Firms That Do Not Declare Bankruptcy

This section has focused primarily on the costs associated with firms declaring bankruptcy because of asbestos liabilities. While it is important to remember that such bankruptcies are unlikely to have substantial macroeconomic effects, it is also important to remember that the bankruptcies do not capture the full effect of asbestos liabilities on defendants to date, nor do they reflect the future costs imposed from ongoing litigation. As noted above, roughly a quarter of estimated total costs to defendants and insurers have been paid to date.

The companies facing significant asbestos liabilities and that have not declared bankruptcy are spread throughout the economy, representing nearly every industry group.[79] Among the companies facing such claims are a major paper and forest products company, a major media conglomerate, and leading transportation firms. For example, the major media conglomerate reported 118,000 asbestos claims outstanding against it as of June 30, 2002 – and during the second quarter of 2002 alone, it received 9,700 new claims. One major industrial firm, which never produced or sold asbestos, faces as many as 74,700 claims because its "dust masks" did not adequately protect against asbestos.

As *Fortune* magazine recently noted, "The filings by workers in so-called nontraditional industries -- industries in which employees seldom come anywhere near asbestos dust -- have skyrocketed. Filings in the textile industry, for instance, jumped more than 721% in the past two years, according to one defendant's records; in the pulp and paper industries, 296%; in the food and beverage industries, 284%. Companies like Chiquita Brands, General Electric, and Sears Roebuck have all been hit with asbestos suits."[80]

The uncertainty surrounding such claims raises borrowing costs and reduces equity values for the firms, thereby impeding their activities. It may also discourage firms from merging, even when such mergers would make economic sense. We have not attempted to quantify the economic effects of asbestos claims against firms that have not (or not yet) declared bankruptcy.

IV. Conclusions

A large component of the payments made to asbestos claimants involves transfers from workers at the defendant firms. The pain and suffering of the impaired claimants is palpable; the costs imposed on the workers in the defendant firms is often less clear. The purpose of this paper is <u>not</u> to suggest that impaired claimants are unworthy of assistance, but rather to highlight the fact that payments to any claimants are not free. They impose significant costs on the workers and shareholders of the defendant firms. Since many of these firms were not asbestos manufacturers, the costs imposed on workers may seem unfair and inefficient from an economic perspective.

As we describe above, bankruptcies associated with asbestos liabilities have had a marked deleterious effect on workers in those firms. Employment declines at these firms have amounted to between 52,000 and 60,000 jobs. The displaced workers typically

[79] See Stephen Carroll et al. (2002).
[80] See Parloff (2002).

suffer periods of unemployment before finding a new job, and then often must accept a reduction in wages in order to become re-employed. The costs imposed on these displaced workers amount to between $1.4 billion and $3.0 billion in present value, or roughly $25,000 to $50,000 per displaced worker.

These costs are not the only ones imposed on workers at the bankrupted firms. For example, workers at many firms are also shareholders in the firm, since they hold company stock in their defined contribution pensions. The average worker at a bankrupted firm with a 401(k) plan suffered roughly $8,300 in losses. For a 45-year-old worker with an average 401(k) balance, such a loss would mean his retirement income would fall by $1,250 per year. To prevent such a decline, he would have to raise his annual 401(k) saving before retirement by $720 per year.

In light of these costs, re-examining the system used to compensate those with illnesses associated with asbestos exposure seems worthwhile. In the context of asbestos, the beneficial incentive effects often associated with a product liability system are attenuated because claims are increasingly being extended to a wider array of firms. The liability approach also involves significant transaction costs. Finally, the liability approach raises basic questions of fairness. Citizens who have suffered from asbestos-related illnesses deserve appropriate compensation. The crucial issue, however, is how we as a society decide to meet those costs.[81] The current system does not appear to an optimal mechanism for doing so.

[81] Supreme Court Justice David Souter wrote that "The elephantine mass of asbestos cases... defies customary judicial administration and calls for national legislation." See *Ortiz et al. v. Fibreboard Corp et al.*, Docket 97-1704, (decided June 23, 1999). Similarly, Senator Patrick Leahy, the Chairman of the Senate Judiciary Committee, recently stated that "Congress can provide a secure, fair, and efficient means of compensating victims." See Senator Patrick Leahy, Statement before the Senate Judiciary Committee, September 25, 2002.

References

Altman, Edward. 1984. "A Further Empirical Investigation of the Bankruptcy Cost Question." *Journal of Finance*, Volume 39, Issue 4 (September), pages 1067-1089.

A.M. Best. 2001. *Asbestos Claims Surge Set to Dampen Earnings for Commercial Insurers*. May 7.

American Academy of Actuaries. 2001. *Overview of Asbestos Issues and Trends*. December.

Brickman, Lester. 1992. "The Asbestos Litigation Crisis: Is There a Need for an Administrative Alternative?" *Cardozo Law Review*, Volume 13.

Brown, Stephen, and Jerold Warner. 1985. "Using Daily Stock Returns: The Case of Event Studies." *Journal of Financial Economics* 14 (Summer), pages 3-31.

Bureau of Labor Statistics. 2001. Monthly Labor Review: The Editor's Desk, "Finding a New Job After Displacement," July 18.

Card, David, and Alan Krueger. 1995. *Myth and Measurement: The New Economics of the Minimum Wage*. Princeton, NJ: Princeton University Press.

Carroll, Stephen et al. 2002. "Asbestos Litigation Costs and Compensation: An Interim Report." RAND Institute for Civil Justice.

Castleman, Barry. 1996. *Asbestos: Medical and Legal Aspects*. Englewood Cliffs, NJ: Aspen Law & Business.

Edley, Christopher, and Paul Weiler. 1993. *Asbestos: A Multi-Billion Dollar Crisis*, *Harvard Journal on Legislation*, Volume 30.

Farber, Henry. 2001. "Job Loss in the United States, 1981-1999." Princeton University Industrial Relations Section Working Paper #453, June.

Franks, J. and W. Touros. 1989. "An Empirical Investigation of U.S. Firms in Reorganization." *Journal of Finance*. Volume 44, pages 747-770.

Helwig, Ryan T. 2001. "Worker Displacement in a Strong Labor Market," *Monthly Labor Review*. June, Vol. 124, No. 6.

Kakalik, James et al. 1984. *Variation in Asbestos Litigation Compensation and Expenses*. RAND Institute for Civil Justice, R-3132-ICJ.

Lehman Brothers. 2002. *Thinking About Asbestos*. March 20.

Lyon, Andrew. 1989. "The Effect of the Investment Tax Credit on the Value of the Firm." *Journal of Public Economics*, Volume 38, pages 227-247.

Mullin, George, Joseph Mullin, and Wallace Mullin. 1995. "The Competitive Effects of Mergers: Stock Market Evidence from the U.S. Steel Dissolution Suit." *RAND Journal of Economics* 26 (Summer), pages 314-330.

Munnell, Alicia, and Annika Sunden. 2002. "401(k)s and Company Stock: How Can We Encourage Diversification?" Center for Retirement Research, Boston College, July.

Nicholson, William et al. 1982. "Occupational Exposure to Asbestos: Population at Risk and Projected Mortality: 1980-2030." *American Journal of Industrial Medicine*. Volume 3, pages 259-311.

Parloff, Roger. 2002. "The $200 Billion Miscarriage of Justice." *Fortune*. March 4.

Plevin, Mark, and Paul Kalish. 2001. "What's Behind the Recent Wave of Asbestos Bankruptcies?" *Mealey's Litigation Reports: Asbestos*, April, available at http://www.crowell.com/pdf/Behind.pdf

Prudential Financial. 2002. *Asbestos Litigation – A Problem Without a Solution*. May 6.

Schipper, Katherine, Rex Thompson, and Roman Weil. 1987. "Disentangling Interrelated Effects of Regulatory Changes on Shareholders Wealth: The Case of Motor Carrier Deregulation." *Journal of Law and Economics* 30 (April), pages 67-100.

Stiglitz, Joseph. 1972. "Some Aspects Of The Pure Theory Of Corporate Finance: Bankruptcies And Take-Overs," *Bell Journal of Economics and Management Science*, Volume 3, Issue 2 (Autumn), pages 458-482.

Sunden, Annika, and Brian Surette. 2000. "Household Borrowing from 401(k) Plans," Center for Retirement Research, Boston College, June.

Weiss, Lawrence. 1990. "Bankruptcy Resolution: Direct Costs and Violation of Priority Claims." *Journal of Financial Economics*. Volume 27, pages 285-314.

White, Michelle. 2002. "Why the Asbestos Genie Won't Stay in the Bankruptcy Bottle." Presented at the University of Cincinnati College of Law Conference on "Bankruptcy and Corporate Reorganization in the New Millennium," March 1.

White, Michelle. 1996. "The Costs of Corporate Bankruptcy: A U.S.-European Comparison," in *Corporate Bankruptcy: Economic and Legal Perspectives*. J. Bhandari and L. Weiss, eds. Cambridge: Cambridge University Press.