ASBESTOS PRE-PACKAGED BANKRUPTCIES: APPLY THE BRAKES CAREFULLY AND RETAIN FLEXIBILITY FOR DEBTORS

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In their recent article, *From Free-Fall to Free-For-All: The Rise of Pre-Packaged Bankruptcies*, former Bankruptcy Judge Ronald Barliant and his co-authors raise concerns about the potential for abuse in pre-packaged asbestos bankruptcies and propose that judges apply procedural brakes to certain practices that have arisen in disposing of these cases.[1] Some of the potential for abuse described by the article is real. However, Barliant wrongly locates the abuse with the aggressive intent of debtors-in-possession and proposes remedies that need to be tailored more carefully to retain flexibility for debtors who must deal with the statutorily-imposed barriers to financially realistic outcomes.

Judge Barliant correctly observes that in asbestos-related reorganizations there is a heightened potential for conflict because of the presence of "future claimants," those who may have been injured by contact with asbestos but whose disease is not yet known to them due to the "latency period" associated with asbestos-related disease. Therefore, in asbestos-driven reorganizations, there is the usual conflict between and among financial creditors, tort claimants, and debtors-in-possession (the alleged tortfeasor), but there is also an important conflict between "current" tort claimants whose disease is alleged to have already appeared and "future" tort claimants whose disease may or may not ever appear but who wish to be assured of compensation for injuries that arise at some future time.[2] These conflicts play out on a field tilted in such a way that the financial goals of the parties and the statutory goals of corporate reorganization also compete. In particular, *Free-For-All* identifies a pre-packaged bankruptcy tactic that appears to circumvent many of the basic creditor protections provided in Bankruptcy Code[3] section 1125 (the disclosure statement requirement) and section 1129 (plan confirmation standards).[4]

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[1] Ronald Barliant, Dimitri G. Karcazes & Anne M. Sherry, *From Free-Fall to Free-For-All: The Rise of Pre-Packaged Asbestos Bankruptcies*, 12 AM. BANKR. INST. L. REV. 441 (2004).

[2] *Id.* at 456–57 (noting conflict exists because every dollar paid to current claimants is one dollar less for future claimants).

[3] 11 U.S.C. §§ 101–1330 (2000).

[4] Barliant, *supra* note 1, at 458–65.

But Barliant wrongly concludes such tactics are the result of freely made decisions by the debtor-in-possession and, therefore, are the result of intentional debtor planning to seize advantage. In fact, the aggressive tactics he describes are the rational response of chapter 11 debtors to the incentives created by the Bankruptcy Code as modified by section 524(g), the special interest legislation that protects and enforces asbestos claims.

In several recent cases, a pre-petition accommodation has been reached between the debtor and lawyers representing large groups of "current" tort claimants providing for either pre-petition distributions or post-petition claim treatment that assures an advantage over other tort claimants whose rights would appear to be identical.[5] In one variant, these pre-petition arrangements call for financial payouts on account of the tort claim but only partial legal disposition of that tort claim, thereby allowing advantaged claimants to be paid on account of the claim in the pre-petition period while keeping a notional remainder of the claim for voting purposes in a pre-packaged plan process.[6] If done "right," tort claimants who have been bestowed of a pre-petition benefit can mathematically dominate their voting classes, assuring a "yes" vote for confirmation even if future claimants are materially mistreated. The only protection against such a manipulated outcome being unopposed on a motion seeking a bankruptcy judge's blessing for confirmation is the supposedly independent representation of "future" tort claimants. Whether any actual future claimants' representative can or does have real independence from the guild of tort lawyers representing "current" tort claimants is a complex subject beyond the scope of this brief reply to Judge Barliant. For our purposes, suffice it that such future claimant's representatives have participated in schemes like the ones described and advocated confirmation notwithstanding the apparent lack of fairness to certain current and likely all future claimants.[7]

A key question, not addressed by *Free-For-All*, and extremely important in redressing the inequities that have been statutorily grafted onto the bankruptcy

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[5] *See In re* ACandS, Inc., 311 B.R. 36, 39–41 (Bankr. D. Del. 2003) (outlining pre-petition settlement trust creating arbitrary classes of disparately treated asbestos claimants); Certain Insurers' Brief at 17–24 , *In re* Congoleum Corp., No. 03-51524, 2005 Bankr. LEXIS 556 (Bankr. D. N.J. Jan. 5, 2004) (describing plan's treatment of claimants who settled pre-petition compared to those who didn't); *see also* Mark D. Plevin, Robert T. Ebert & Leslie A. Epley, *Pre-Packaged Asbestos Bankruptcies: A Flawed Solution*, 44 S. TEX. L. REV. 883, 899–903 (2003) (describing how pre-petition settlement trust in Combustion Engineering's bankruptcy discriminated against future claimants).

[6] In J.T. Thorpe Company's bankruptcy, participants in pre-petition settlement trusts were given secured claims equal to 75% of their settlement amount and unsecured claims for the remaining 25%. These participants were allowed to vote on the unsecured portion of their claims. *See* Plevin, *supra* note 5, at 892–97.

[7] *See, e.g.*, Disclosure Statement, *In re* ACandS, Inc., 311 B.R. 36 (Bankr. D. Del. Oct. 3, 2003) (No. 02-12687); Disclosure Statement, *In re* Shook & Fletcher Insulation Co. (Bankr. N.D. Ala. 2002) (No. 02-02771); Disclosure Statement, *In re* J.T. Thorpe Co., 308 B.R. 782 (Bankr. S.D. Tex. Aug. 13, 2002) (No. 02-41487). No plan in an asbestos bankruptcy has been approved over the objection of a futures representative.

system applicable only to asbestos cases, is why a sophisticated corporate debtor would engage in negotiations leading to such an unfair and arguably unnecessary result. The inference that can be drawn from *Free-For-All* is that debtors are, in some manner, in cahoots with the dominant asbestos lawyers to deny other (less well represented or just less fortunate) claimants fair compensation for their injuries. But intuitively this should not be, and indeed experience indicates it is not, the case.

In fact what has happened is that in 1994 Congress enacted section 524(g)[8] of the Bankruptcy Code, a very flawed piece of special interest legislation developed by the special interest holders themselves.[9] The methods and inherent conflicts of section 524(g), including the virtual impossibility of confirmation by cramdown on tort claimants (*i.e.*, confirmation over their objection) and the practical limitations on an "independent" future claimants' representative, have forced debtors to acquiesce and to do quickly whatever they can to minimize the enterprise-threatening stress of a drawn-out bankruptcy. Under the system imposed by section 524(g), the practical dictates of enterprise preservation encourage debtor managements to help tort lawyers maximize recoveries from insurers and non-tort claimants (banks, bonds, trade creditors, pensioners and the like). Debtor managements that try to fight this value-destroying system risk drawing out their stay in chapter 11 resulting perhaps in a chance at a just result, but also increasing damage to their competitive franchises, multiplying their restructuring costs, and suffering the rebukes of bankruptcy judges who find their efforts inconsistent with the apparent intent of the statute: to allow the tort lawyers to dictate a large swath of the reorganization outcome.[10]

In our article, *The Patronus Technique*, we point out one possible way for debtors to address the growing disequilibrium of negotiating leverage and for asbestos claims to be handled in strategically structured bankruptcy proceedings.[11] We propose corporate debtors can create a special-purpose subsidiary in order to facilitate a settlement and shield the larger corporate defendant from bankruptcy; and this special-purpose subsidiary can commence a chapter 11 case in order to

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[8] *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 111, 108 Stat. 4106, 4113–16 (1994) (codified at 11 U.S.C. § 524(g) (2000)).

[9] *See* Boe W. Martin, *Solution or Setback for Mass-Tort Bankruptcies?*, COMMERCIAL LENDING LITIGATION NEWS, Apr. 7, 1995 (describing 524(g) as "the culmination of an intensive lobbying effort . . . .").

[10] A striking example of this latter frustration is Judge Newsome's action in the Federal-Mogul bankruptcy to stop management's effort to raise capital sponsorship for its plan of reorganization that would have allowed it to emerge substantially less leveraged than otherwise. *See* Bruce A. Carr, *Federal-Mogul Reorganization Hits Setback*, THE EBEARING NEWS, Oct. 7, 2003, http://www.ebearing.com/news2003/100701.htm. ("The bankruptcy court judge overseeing Federal-Mogul's operations denied its request to exclusively negotiate a USD $350 million investment by Citigroup Venture Capital Equity Partners L.P."). In the opinion of the authors, this also would likely have avoided the multi-year delay currently occurring as vulture investors seek to minimize payments to certain non-U.S. pensioners.

[11] Todd R. Snyder & Deanne C. Siemer, *The Patronus Technique: A Practical Proposal for Asbestos-Driven Bankruptcies*, 11 J. BANKR. L. & PRAC. 357 (2002).

secure the benefits of bankruptcy with respect to a final binding resolution of the asbestos claims. This technique places the debtor in a position to truncate the bankruptcy proceedings in order to minimize adverse operational and financial effects and preserve the assets available for distribution.[12] The article spells out the reasons why this approach is consistent with bankruptcy law, necessary for corporate debtors with asbestos liabilities and acceptable to the lawyers representing tort claimants.

The special circumstances in asbestos litigation that make it necessary to consider the Patronus Technique are an enormous roadblock to rational distributions in reorganization. Claimants who are classified as "unimpaired" when they present their claims may, in fact, also be "uninjured." The term "unimpaired," is used in asbestos cases to mean "not yet sick." A person who was exposed to asbestos some years ago may be unimpaired at present time because the damage from exposure to asbestos dust, like exposure to tobacco smoke, may take a very long time to result in disease—the latency period mentioned above. If the "unimpaired" claimant in fact has no asbestos exposure or no injury from asbestos exposure, then under traditional tort law he or she is entitled to no recovery on a claim. However, in the world of asbestos claims, over the past 20 years, traditional tort law has been shoved aside. A concurrent series of developments in the way asbestos plaintiffs are represented—resulting in tens of thousands of claims being prosecuted by a small group of lawyers—and the failure of judicial process to weed out the injured from the uninjured has resulted in unprecedented risk for corporations. This, together with the special protections under section 524(g), lobbied into place by tort lawyers, has upended the balance of negotiating leverage between debtors and creditors under the Bankruptcy Code and has led corporate officers to resort to utilizing the Bankruptcy Code in creative ways. For many corporations with asbestos liabilities, the choice is creative bankruptcy or slow death. The procedural concerns expressed in *Free-For-All* do not take adequate account of the slow death imperative.

Claims by plaintiffs who are not sick raise two difficult problems for bankruptcy courts. First, there are tens of thousands of such cases because "unimpaired" status is easy to claim and therefore lawyers who specialize in asbestos cases have accumulated large inventories of claims which they assert against one asbestos defendant after another. Second, the valuation of such claims is very time consuming because of the very large number of claimants and the uncertainty about the specific injury. In order to gain leverage in the bankruptcy proceedings, the asbestos lawyers assert a very high aggregate value for their inventories of claims and resist any effort to require them to prove the individual value of these claims. For example, in the Federal-Mogul bankruptcy,[13] the asbestos lawyers asserted about 60,000 claims and valued them in the aggregate at

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[12] *See id*. at 371–80 (discussing Patronus Technique).

[13] *In re* Federal-Mogul Global, Inc., No. 01-10578 (Bankr. D. Del. Oct. 1, 2001).

$7 billion.[14] To date, in a bankruptcy ongoing for almost four years and still underway, the bankruptcy judge never determined the value of a single one of those claims.

To bring into focus the difficulty management faces in devising a practical solution under these circumstances, consider the questions: (1) How can a debtor deal with representatives of tort claimants, who by attributing an estimated value to the claims (particularly of the unimpaired) can arrive at totals in the billions, if these claims are too numerous to be valued or estimated in a bankruptcy court? (2) How can a debtor negotiate successfully with representatives of tort claimants who cannot be circumvented by the financial logic of the cramdown provision of section 1129(b) and therefore have an unlimited capability to hold hostage any plan of reorganization?

In a recent case, federal District Court Judge Janis Graham Jack examined 111 silicosis cases involving more than 10,000 individual plaintiffs.[15] Silicosis cases arise in a manner similar to asbestos cases because they rest on exposure to a particular kind of dust that can result in lung damage. Judge Jack found,

> [T]he clear motivation [of plaintiffs' lawyers] . . . was to inflate the number of Plaintiffs and claims in order to overwhelm the Defendants and the judicial system. This is apparently done in hopes of extracting mass nuisance-value settlements because the Defendants and the judicial system are financially incapable of examining the merits of each individual claim in the usual manner.[16]

Judge Jack sanctioned one law firm for this conduct, pointing out that,

> It is worth noting that the amount of the sanction this Court ultimately orders . . . , while not insignificant, will be substantially less than the total amount of damages—some calculable and some not—Plaintiffs' counsel have caused by their filing of thousands of claims without a reliable basis for believing that every Plaintiff has been injured.[17]

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[14] *See* Informational Brief of the Debtor at 3, 21–24, *In re* Federal-Mogul Global, Inc., No. 01-10578 (Bankr. D. Del. Oct. 1, 2001).

[15] *In re* Silica Prods. Liab. Litig., No. 1553, 2005 WL 1593936, at *1 (S.D. Tex. June 30, 2005).

[16] *Id.* at *95

[17] *Id.* at *98. In a recent hearing on Aug. 22, 2005, Judge Jack questioned a plaintiff's lawyer about the claimants in one silicosis lawsuit who previously claimed to have asbestosis. The judge had heard medical testimony to the effect that it is very rare for a person to have both silicosis and asbestosis, yet 70% of the approximately 100 plaintiffs in this case had filed both kinds of claims. To support his silicosis claims, the lawyer told the judge he doubted that these plaintiffs ever had a real asbestosis claim. *See* transcript reprinted at WALL STREET JOURNAL, Aug. 31, 2005, p. A8.

In an attempt to counterbalance the practical concerns of bankruptcy practitioners and dealmakers which are driving asbestos transactions to the edge of and beyond the statutory authority of Bankruptcy Code section 524(g), *Free-For-All* seeks to force an equitable and necessarily malleable negotiation process in the direction of statutory rigidity.[18] *Free-For-All* proves too much; in the service of correcting obvious advocacy-driven overreaching, it risks replacing practical solutions with a carefully parsed, but uselessly turgid, reading of the Bankruptcy Code. In particular, *Free-For-All*'s view of the Patronus Technique[19] not only misses the point of the Technique itself[20] but also invests the legislative process that gave rise to section 524(g) with an independence and evenhandedness it surely does not deserve. If, in practice, there is a disproportion of negotiating leverage to be corrected, it is disproportionate leverage favoring asbestos claimants.[21] Under current circumstances, debtors-in-possession have too little, not too much, flexibility leaving them prey to avarice and expedience.

Free-For-All comments: "Whether the Patronus Technique is permissible under the Code or whether it is sound on a more basic level is not for this article to debate. What is clear is that this result is not what Congress had in mind when it enacted section 524(g)."[22] *Free-For-All* cites no legislative history to support this proposition because the legislative process that created section 524(g) was carefully managed to give the lawyers representing tort claimants maximum flexibility, and it contains almost no guidance on how section 524(g) was supposed to operate. H.R. 5116,[23] the bill that created section 524(g), arrived on the floor of the House with a motion by Rep. Jack Brooks (D. Texas), the Chair of the Judiciary Committee, to suspend the rules and pass the bill. Rep. Brooks' very short and general introductory remarks said nothing about section 524(g).[24] Rep. Hamilton Fish (R. N.Y.), the ranking minority member of the committee, provided only this very short

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[18] Barliant, *supra* note 1, at 467–69 (discussing problems with pre-petition negotiations).

[19] *Id.* at 459 (stating section 524(g)'s requirement asbestos claim trusts be funded with debtor's securities would be worthless if it could be satisfied with shares of shell company). However, a subsidiary need not deal only in its own shares. The parent can vest the Patronus subsidiary with sufficient cash or other assets of the parent company to make the contribution to a trust sufficiently secure to win the support of asbestos claimants. Indeed, the parent company would inevitably do so, otherwise the Patronus subsidiary would not reach a consensual settlement with the asbestos claimants and their representatives.

[20] The Patronus Technique is designed to serve the same policy goals as the Bankruptcy Code: corporate reorganization and rehabilitation, maximization of reorganization value, and equitable distribution of that reorganization value among competing claimants. *See* Snyder & Siemer, *supra* note 11, at 371–80.

[21] For example, provisions of section 524(g) protect asbestos plaintiffs from any risk of cramdown under section 1129(b), a risk virtually all other stakeholders face in negotiating a fair deal.

[22] Barliant, *supra* note 1, at 459.

[23] Bankruptcy Reform Act of 1994, H.R. 5116, 103d Cong. § 111 (1994).

[24] *See* 140 CONG. REC. H10752, H10764 (daily ed. Oct. 4, 1994). Section 111 of the bill entitled "Supplemental Injunctions" (a part of the lengthy and very detailed Bankruptcy Reform Act of 1994) contained the amendment that added subsection (g) to section 524. Brooks supplemented the record with a written section-by-section analysis. *See* 140 CONG. REC. H10764–71 (daily ed. Oct. 4, 1994). The section-by-section analysis also refers to the need to create certainty in establishing trusts.

explanation of section 524(g): "We clarify judicial authority to issue injunctions in certain circumstances where trusts are created to pay asbestos related claims—because we recognize that by removing uncertainty over the validity of such injunctions, the value of trust assets available to fund recoveries by victims can increase." [25] The bill passed without any debate.

Section 524(g) was developed and supported by the lawyers who hold large inventories of asbestos claims in order to make the establishment of asbestos trusts a practical solution for settlements that could bind future claimants. Without the ability to dispose of all asbestos claims, present and future, corporations had much less incentive to make very large settlements. So, to the extent Congress intended anything in this regard, it intended what the plaintiffs' bar sought to achieve. Somewhat counter-intuitively, the unequal bargaining leverage in favor of tort claimants that is codified in section 524(g) is best addressed by allowing debtors to reach swift and practical compromises with tort claimant representatives if they are in the debtors' best interests; either that or by materially rethinking and likely rewriting section 524(g). Sticking to a rigid format supposed by *Free-For-All* to reflect "legislative intent" only prolongs a battle the debtors cannot realistically win under current law and almost invariably diminishes reorganization value.

The goal of the Patronus Technique is to provide an escape from a value-deleting process without risking a further extension of bankruptcy litigation. This goal, we believe, must be embraced if debtors are to have a chance to survive bankruptcy and maximize distributable reorganization value. As we said in 2002, and as remains true today, federal legislation to solve the asbestos problem is not going to happen soon.

Free-For-All wrings its hands over compromised procedural protections in asbestos-driven pre-packaged bankruptcies. But it misses the central point, which is that the vast majority of asbestos claims are either invalid or overstated and yet Congress gave these claims the tools to dictate reorganization outcomes. Under section 524(g), the highly-organized lawyers for asbestos claimants have wrested control of the reorganization process from the appropriate fiduciaries of the bankruptcy estate. This shift in leverage risks serious diminution of reorganization value and inequity of value distribution unless other measures are implemented. While some (but certainly not all) efforts of corporate management at pre-packaged bankruptcies may have run afoul of chapter 11 protections, managers surely should not be faulted for trying—even where the result is an effective turnover of value and control to the lawyers representing tort claimants—*for this is the result apparently sought by section 524(g)*. The Patronus Technique is a practical effort to get to the same result without gratuitous destruction of value and violation of procedural protections.

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[25] 140 CONG. REC. H10772 (daily ed. Oct. 4, 1994).