



POTENTIAL IMPACT OF THE FAIRNESS IN ASBESTOS INJURY RESOLUTION ACT OF 2005 (S. 852) ON POLICYHOLDERS

May 6, 2005

On April 19, 2005, Senator Arlen Specter introduced the “Fairness in Asbestos Injury Resolution Act of 2005” (the Act), S. 852, 109th Cong. (2005). The legislation would create a “privately funded, publicly administered” \$140 billion trust fund (the Fund) to compensate asbestos claimants. S. 852, 109th Cong. § 2(b) (2005) (hereinafter “§ xx”). The Fund would be financed by annual payments made by asbestos defendants and their insurers. Defendants would be required to make annual payments for 30 years, subject to increases declared by the fund administrator. Any sale or transfer of assets – or even bankruptcy – would have no effect on these required payments. Also, while the Act generally provides for a stay of pending asbestos claims, exceptions to this provision could result in the most financially significant claims moving forward despite the Act. The legislation is not a “permanent solution”. If the Fund cannot meet its financial obligations, then all asbestos suits will return to the existing tort system. Under the Act as proposed, insurance coverage for asbestos claims will disappear upon enactment, **along with a significant portion of insurance responsive to non-asbestos claims, such as environmental liabilities (for premises defendants) and for silicosis and other claims (for products defendants)**, leaving most companies with reduced insurance for other currently covered “long tail” liabilities.

1. Asbestos Defendants Will Pay \$90 Billion For the \$140 Billion Fund, Insurers Will Pay Only Half of This Amount, or \$46 Billion, and All Asbestos Trust Will Have To Pay Over All of Their Assets to the Fund.

Under the proposed legislation, within six months after its enactment, \$4 billion will be transferred to the Fund from bankruptcy trusts that currently are funding asbestos liabilities. § 402 (adding new § 524(j)(2) to the Bankruptcy Code). An additional \$90 billion will be paid in the next three decades by companies that have been sued for asbestos-related injuries (defendant-participants) through 30 annual payments to the Fund. §§ 202(a)(2) & 204(a)(1). Defendant-participants will not be able to use insurance to pay or be reimbursed for payments of this annual “tax.” § 404(d)(2). “Insurer-participants” – those insurers that have been assessed at least \$1 million in defense and indemnity costs before the Act’s enactment date – will make a total contribution of about half of that of the other participants – \$46 billion. § 212(a)(2)(A). Additionally, insurer-participants will receive the benefit of having either the defendant-participants’ aggregate product liability limits or their coverage limits responsive to premises liability claims that otherwise would be available for non-asbestos-related liabilities “eroded,” meaning eliminated. §§ 404(a)(2)(A) & 404(a)(2)(E).

2. Annual Payments to the Fund and Tax Implications

The amount of a defendant-participant’s annual payment to the Fund will be determined by its position in one of seven “tiers.” Tier I consists of defendant-participants that are currently in

bankruptcy and that have prior asbestos expenditures of \$1 million or greater. § 202(b). Tier VII consists of defendant-participants that have been subject to asbestos claims brought under the Federal Employers’ Liability Act, 45 U.S.C. § 51 *et seq.*, as a result of operations as a common carrier by railroad. § 203(h). Under the proposed legislation, Tier VII defendant-participants fall into one of three subtiers based on the company’s revenues. Tier VII defendant-participants with revenues of \$6 billion or more would fall under Subtier 1 and be required to make annual payments of \$11 million. § 203(h)(3). Those with between \$4 billion and \$6 billion in revenues would fall under Subtier 2, with a \$5.5 million annual payment. § 203(h)(4). And those with between \$500 million and \$4 billion in revenues would pay \$550,000 annually under the proposed legislation. § 203(h)(5). If a Tier VII defendant-participant also qualifies to be included under Tier II, III, IV, V or VI, it would have to make the additional annual payments required of a defendant-participant under that tier. § 203(h)(2).

Whether a defendant-participant falls into Tier II, III, IV, V or VI depends on the amount of its “prior asbestos expenditures,” currently defined in the bill as expenditures made on or before December 31, 2002 for both defense and indemnity of asbestos claims. §§ 201(g) 202(d). Payments made by an insurer on behalf of a company would count toward the company’s prior asbestos expenditures, not the insurer’s. §§ 201(g) 202(d)(7) & 204(g). It is possible that the date by which prior asbestos expenditures are calculated may be moved to a more recent fiscal year so as to include more participants in higher tiers and to avoid legal challenges founded upon *ex post facto* arguments.

For tiers other than Tier I and Tier VII, once a defendant-participant’s “tier” is determined, a subtier is assigned based on its gross revenues as of the fiscal year ending December 31, 2002. § 203(a)(2). The defendant-participants with the highest gross revenues within a tier will be placed in the top subtier, and those with the lowest in the last subtier. *See, e.g.*, § 203(d)(1). Each member of a subtier is required to make the 30 equal annual payments provided for in the Act for defendant-participants belonging to that subtier. *See* § 203(c)-(f). Below is a chart that lists the annual and total payments by subtier for Tiers II through VI.

TIER AND SUBTIER	PRIOR ASBESTOS EXPENDITURES	2005 FAIR ACT PAYMENTS	
		Annual Payment	Total Payment
TIER II (§ 202(d)(1))	> \$75 MM		
SUBTIER 1 (§ 203(c)(2)(A))		\$27,500,000	\$825,000,000
SUBTIER 2 (§ 203(c)(2)(B))		\$24,750,000	\$742,500,000
SUBTIER 3 (§ 203(c)(2)(C))		\$22,000,000	\$660,000,000
SUBTIER 4 (§ 203(c)(2)(D))		\$19,250,000	\$577,500,000
SUBTIER 5 (§ 203(c)(2)(E))		\$16,500,000	\$495,000,000
TIER III (§ 202(d)(2))	> \$50 MM, < \$75 MM		
SUBTIER 1 (§ 203(d)(2)(A))		\$16,500,000	\$495,000,000
SUBTIER 2 (§ 203(d)(2)(B))		\$13,750,000	\$412,500,000
SUBTIER 3 (§ 203(d)(2)(C))		\$11,000,000	\$330,000,000
SUBTIER 4 (§ 203(d)(2)(D))		\$8,250,000	\$247,500,000
SUBTIER 5 (§ 203(d)(2)(E))		\$5,500,000	\$165,000,000
TIER IV (§ 202(d)(3))	> \$10 MM, < \$50 MM		
SUBTIER 1 (§ 203(e)(2)(A))		\$3,850,000	\$115,500,000
SUBTIER 2 (§ 203(e)(2)(B))		\$2,475,000	\$74,250,000
SUBTIER 3 (§ 203(e)(2)(C))		\$1,650,000	\$49,500,000
SUBTIER 4 (§ 203(e)(2)(D))		\$550,000	\$16,500,000
TIER V (§ 202(d)(4))	> \$5 MM, < \$10 MM		

SUBTIER 1 (§ 203(f)(2)(A))		\$1,000,000	\$30,000,000
SUBTIER 2 (§ 203(f)(2)(B))		\$500,000	\$15,000,000
SUBTIER 3 (§ 203(f)(2)(C))		\$200,000	\$6,000,000
TIER VI (§ 202(d)(5))	> \$5 MM, < \$10 MM		
SUBTIER 1 (§ 203(g)(2)(A))		\$500,000	\$15,000,000
SUBTIER 2 (§ 203(g)(2)(B))		\$250,000	\$7,500,000
SUBTIER 3 (§ 203(g)(2)(C))		\$100,000	\$3,000,000

The payments noted are subject to surcharge in the event of a shortfall. To the extent that, in any given year, total payments by defendant-participants exceed \$3 billion, the Fund Administrator is to place the excess funds in a “guaranteed payment account” upon which the Fund Administrator may draw in the event of a shortfall in the annual aggregate minimum payment in a future year. § 204(h)(1), (2), (k). In the event that the guaranteed payment account has funds insufficient to cover such a shortfall, the Fund Administrator may impose a “guaranteed payment surcharge” to make up the difference. § 204(h)(3), (l). Further, unlike earlier asbestos legislation, the Act does not prohibit future amendments providing for additional annual payments. *See* S. 2290 § 204(m), 108th Cong. (2004).

The Act does not clearly state how this new assessment will be treated for federal and state income tax purposes, or for accounting purposes. Although payment of asbestos-related expenses, such as attorneys’ fees and the like, would ordinarily be a deductible ordinary and necessary expense for both federal and state tax purposes, it is also the case that the receipt of insurance proceeds, unless matched by an offsetting deduction, would ordinarily be treated as income reportable for both federal and state tax purposes. It would be reasonable to conclude that the sum of payments should be deductible for all purposes, but this remains unclear under the Act. Equally unclear is the accounting treatment for the tax proposed under the Act. Because the 30 years of payments could be deemed to be both “probable” and “estimable,” since the obligation cannot be extinguished, returned, or transferred, it would appear that the entire payment stream required under the Act would have to be recorded, perhaps for both balance sheet and income statement purposes. Again, the Act is unclear on these issues. Nor does it provide any guidance in terms of its potential relationship with other federal laws, such as Sarbanes-Oxley.

3. Effect of the Act on the Transfer or Sale of Assets, or Bankruptcy

The bill provides that a company’s initial assignment to a tier and subtier are permanent *“for the life of the Fund regardless of subsequent events.”* § 202(e)(1). The sale or transfer of any assets of a defendant-participant will not reduce the annual payments due under the Act. § 202(e)(1)(D). Thus, even if a company sells or transfers some or all of its assets, its obligation to make annual payments to the Fund will remain. The statute does not discuss what would happen if two Fund participants merge, or if a defendant-participant is merged into another entity not subject to the Act. In the former case, it can be assumed that the new entity would be required to make both annual payments. As to the latter, considering the language and purpose of the bill, it is doubtful that it could be interpreted as allowing a defendant-participant to “merge away” its obligations to the Fund.

If a defendant-participant files for bankruptcy protection under Chapter 11 of the United States Code after the enactment of the Act, that defendant-participant’s annual payment would be considered “costs and expenses” under 11 U.S.C. § 503. § 202(e)(1)(A), (2)(A). As a result, such payments would be considered “actual, necessary costs and expenses of preserving the estate” and would have *priority over creditors’ claims*. 11 U.S.C. § 503(b)(1)(A). The proposed legislation is silent as to

bankruptcy filings pursuant to other provisions of the Bankruptcy Code or whether the Fund administrator would be able to accelerate all payments due under the Act.

4. Temporary Partial Stay of Asbestos Claims Upon Enactment

Upon enactment, the bill provides for a temporary partial stay of all pending asbestos claims – except those currently “on trial” and those for which a verdict or final order has been entered. However, if the Fund is not operational and paying claims *within nine months of enactment*, those stayed claims involving claimants with “exigent health claims,” such as those with mesothelioma or those whose life expectancy is less than one year due to an asbestos-related illness, will be allowed to proceed in court. § 106(f)(2)(B)(i), (iv). Because of the complicated administrative infrastructure and funding requirements that must be met before the Fund can become operational, there is significant likelihood that such “exigent” claims, which have significant financial consequences, and which may comprise the majority of a company’s asbestos-related costs, will proceed through the court system.

The bill also provides for the return of all pending claims to the traditional court system if the Fund cannot meet its obligations within 24 months of the date of enactment. § 106(f)(3)(A). This “kick out” also takes place if, at any point during its life, the Fund is terminated or otherwise cannot meet its obligations. All such cases would at that point return to the tort system.

5. Effect on Insurance Coverage

All insurance coverage for asbestos-related claims will be forfeited upon enactment. *This forfeiture also affects insurance that may be responsive to other non-asbestos-related claims, including environmental claims.* For those defendant-participants with more than 25 percent of their prior asbestos expenditures arising out of product liability claims, their aggregate product liability limits provided under policies with no asbestos exclusions will be “eroded” upon enactment of the Act by an amount equal to 38.1 percent of that defendant-participant’s “scheduled payment amount.” § 404(a)(2)(A). The “scheduled payment amount” is the total future payment obligation of the defendant-participant. § 404(a)(1)(E). This means that a Tier IV, Subtier 1 defendant-participant with \$15 million in historic asbestos expenditures arising mostly out of product liability claims will (i) pay \$115.5 million to the Fund over 30 years, (ii) forfeit all of its insurance coverage for asbestos-related claims, and (iii) find \$44,005,500 of its aggregate product liability limits eroded on the day the Act is enacted. As a general matter, this “erosion” would be allocated among periods in which policies with remaining aggregate product liability limits that are available to the defendant-participant, pro rata by policy period, in ascending order by attachment point. § 404(a)(3)(A). However, this allocation method would be subject to (i) any coverage-in-place or settlement agreement with “insurance participants” of the Fund entered as of the date of enactment of the Act, or (ii) a final judgment as of the date of enactment or resulting from a claim for coverage or reimbursement pending and at the presentation of evidence at trial stage as of the date of enactment. §§ 403(d)(2) & 404(a)(3)(i). If a settlement agreement or final nonappealable judgment in effect as of the date of enactment extinguishes a company’s right to seek coverage for asbestos claims under that insurer-participant’s policies, the aggregate product liability limits of those policies would not be eroded. § 404(a)(3)(ii).

The erosion of aggregate product liability limits provided for in policies with no asbestos exclusions – generally pre-1986 policies – could leave a company with no coverage for long-tail liabilities, including those related to claims caused by products such as Methyl Tertiary Butyl Ether (MtBE).

Since 1979, MtBE has been used as an additive intended to help gasoline burn more smoothly and efficiently after the use of lead was outlawed for that purpose. MtBE claimants assert that environmental damages from the additive pose a \$30 billion problem. (On April 22, 2005, H.R. 6 was passed by the United States House of Representatives (Senate action on the controversial Energy Bill has not been taken) that would provide protection against MtBE-based product liability suits.) The enactment of the Act – purportedly drafted to address the asbestos problem – could erode policyholders’ coverage for MtBE and other long-tail liabilities.

Product liability limits will not erode for “premises defendants” – parties sued based on claims of workplace exposure to in-place asbestos materials. § 404(a)(2)(E). Instead, their coverage limits responsive to premises-based liabilities will erode. *Id.* A “premises defendant” is a defendant-participant that can demonstrate that 75 percent of its prior asbestos-related expenditures were made in defense or settlement of asbestos claims alleging premises-based liability. *Id.* For premises defendants, 75 percent of their payments will erode coverage limits, if any, that are applicable to premises liabilities under “applicable law.” *Id.* The bill does not define “applicable law” or give any indication as to what it might be. Nor does it explain whether the erosion progressively takes place as payments are made each year or whether the full 75 percent of a premises defendant’s total future payment obligation is eroded upon the Act’s enactment. If the Act is enacted, insurers will undoubtedly argue in future environmental coverage litigation that the erosion applies to each and every occurrence – or, as a practicable matter, each and every environmental site. Assuming that the erosion is complete upon enactment, as a practical consequence, this may leave a policyholder with no coverage for environmental claims brought in the future but arising out of historic operations. For example, insurers that issued a Tier IV, Subtier 1 premises defendant \$50,000,000 in per-occurrence limits of coverage could argue that \$86,625,000 in per-occurrence limits have been eroded because occurrence limits are “applicable to premises liabilities under applicable law.”

In the event asbestos claims return to the courts, certain amounts – ***but not all*** – of “eroded” liability coverage would be “restored” based on a formula that takes into account the year in the life of the fund that the termination of coverage took place. § 404(a)(4). For premises liability insurance, the bill is silent as to the restoration of insurance in the event of an early termination of the Fund. As a result, premises defendants would again be forced back to the courts to litigate whether and to what degree their coverage would be “restored.”

In sum, the latest version of proposed FAIR legislation does not significantly increase proposed contributions by insurers, but does dramatically impact the burden on corporate policyholders by eroding in-place insurance assets for products and environmental long-tail risks. The Act also allows for shifting of the financial burden to policyholder companies in the event of insurer insolvency and dissolution.

Senator Specter hopes that the bill will be reported out of the Judiciary Committee and voted on by the Senate during the month of May. On April 28, 2005, the Committee acted on 18 of 82 amendments introduced to address the interests of insurance companies, asbestos claimants, and companies that would have to pay the annual asbestos “tax.” More amendments are expected to be introduced when Congress returns from a one-week recess on May 9. In the House, Rep. Chris Cannon, R-Utah, introduced a bill last week that represented an alternative to the trust-fund approach, which instead would require asbestos claimants to meet stricter uniform medical standards for their claims to proceed in the tort system. Companies that would be affected by either of these approaches to addressing asbestos liability that are not already represented will need to take prompt action if they wish to be heard.

If you would like further information regarding the issues raised in this Morgan Lewis LawFlash, please contact Morgan Lewis partner:

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