Asbestos and the

“An object in motion tends to remain in motion ....”
Judging from the state of asbestos litigation today,
Sir Isaac Newton was far ahead of his time
when he formulated his famous laws.

SIR ISAAC NEWTON WAS ARGUABLY THE GREATEST MATHEMATICAL PHYSICIST IN HISTORY, at least before Albert Einstein arrived on the scene. His accomplishments range from formulating the Newtonian theory of gravity and the laws of motion to inventing differential and integral calculus. In his spare time, he also dabbled in alchemy, which suggests that he knew something about magic. Still, Sir Isaac would be surprised to learn that his teachings accurately describe the asbestos tort environment in the United States in 2005—a crisis marked by ever-escalating personal injury claims, rising company bankruptcies, and numerous failed attempts at legislative and judicial remedies.

**Newton’s First Law of Asbestos:**
**A Tort in Motion Tends to Remain in Motion**
Surely, Sir Isaac had asbestos in mind when he formulated that first law of motion. Asbestos claims continue to be filed at an unprecedented rate, swelling the number of lawsuits waiting to be adjudicated and driving insurance companies’ incurred asbestos losses to new heights. A.M. Best reports that insurance carriers’ incurred asbestos losses for 2001 and 2002 totaled $4 billion and $8 billion, respectively, far eclipsing the previous three-year average of $1.7 billion. Conning & Co. puts the loss for 2003 at more than $7 billion.

The federal and state governments recognize the seriousness of the issue but cannot get meaningful reform passed. The courts, in turn, struggle with how to deal with the sheer magnitude of the litigation.

The premier attempt at tort reform in the recent past was the Fairness in Asbestos Injury Resolution (FAIR) Act (S. 2290), introduced in 2003 by Sen. Orrin Hatch (R-Utah). Still stalled in the Senate, the FAIR Act would have created the Asbestos Injury Claims Resolution Fund to compensate injured asbestos claimants. It calls for the creation of the Office of Special Asbestos Masters within the U.S. Court of Federal Claims to process and evaluate claims and award compensation according to schedules that generally require some level of provable claimant impairment. While the act would require a large funding effort by asbestos defendants and the insurance industry, the defendants would be granted a partial respite from litigation, and the frictional costs of asbestos claims would be greatly reduced.

The size of the trust fund and the related funding requirement proved to be contentious issues during the months of negotiations that followed introduction of the FAIR Act. While expressing support for the idea of a new trust fund, property/casualty trade associations have argued that the industry could not afford a share larger than $46 billion over the life of the fund. Organized labor, meanwhile, maintains that a $114 billion trust fund—the latest version proposed before the bill stalled in April 2004—would not be sufficient to compensate victims.

Other failed attempts at a legislative solution include four measures dealing with asbestos victim compensation and two aimed at reform of the class action process.

Courts and legislatures in some states have tried to deal with the problem in their own way. Lawmakers in Texas, for example, passed a tort reform measure—yet to be tested in the courts—that limits the asbestos liability that companies acquire through acquisitions or mergers. And to expedite the neediest cases, courts in Michigan, Illinois, New York, Texas, and sev-
Asbestos and the
Laws of Newton
eral other jurisdictions have created or are considering creating processes that shift plaintiffs who cannot substantiate claims of physical impairment into inactive dockets. Some of these cases have been dismissed without prejudice, which allows the claimants to sue again at a later date.

**Newton’s Second Law of Asbestos: Cost = Frequency x Severity**

An American Academy of Actuaries analysis (http://www.actuary.org/pdf/casualty/asbestos_040704.pdf) shows that in 2003, more than 100,000 new claims were filed with the Manville Trust, created in 1988 during the bankruptcy of Johns-Manville to compensate victims. Typically, asbestos claimants will file claims with the Manville trust when they sue other parties. While the Academy points out that this level of filings was likely influenced by claimants’ desire to submit their claims before a pending deadline for changing medical criteria, this was the largest number of claims submitted in a single year since at least 1990.

The mix of plaintiffs continues to change as well. According to some estimates, more than 90 percent of asbestos claims don’t involve malignancies linked to asbestos exposure. However, the sheer number of these cases makes dealing with them incredibly difficult, driving the costs of settlements to record heights.

The Academy reports that average jury verdicts for asbestos-related cancer cases increased approximately threefold from 1998 to 2001, while the size of the average verdict in asbestos cases doubled. Although the severity of cases varies from case to case, average settlements in mass torts involving asbestos-related cancer claims can reach six or seven figures per claimant, while a company's average settlement for claims not involving malignancies may be less than $1,000 per claimant for its share of the liability. But with many thousands of asbestos cases pending, it's clear that the total potential costs to the industry are huge.

**Newton’s Third Law of Asbestos: For Every Action, an Equal and Opposite Reaction**

To date, more than 70 companies have gone belly-up as a direct result of the staggering costs of asbestos liabilities. Some 34 of these companies—almost half—have filed for restructuring under the bankruptcy laws in just the past three years. In fact, bankruptcy has become such an effective tool for asbestos case management that bankruptcies are now often “prepackaged.” That is, the bankruptcy plan is written and agreed to in advance, with the aim of completing the process in a matter of months instead of years.

The flood of bankruptcies has spurred plaintiff attorneys to seek other pockets from which asbestos victims can be compensated. Because of the joint and several nature of the liability, companies that had only peripheral involvement in the use of asbestos are now receiving more suit notices and are paying a much larger share of asbestos claims. Rand Corp. estimates that more than 8,400 companies currently are defendants in asbestos cases—an astronomical increase from the American Academy of Actuaries’ estimate of 300 asbestos defendants two decades ago.

**Plaintiff Reactions**

For claimants and their attorneys, the length of time involved in settling a claim may be frustrating, but the results are often favorable once a settlement is reached. From their perspective, the people who have been injured are receiving just compensation from those who deliberately distributed or abetted the distribution of deadly asbestos products, and those responsible are paying their fair share.

The growth in claims is not surprising, considering the long latency period involved in asbestos-related illnesses. Indeed, many claimants are afflicted with asbestosis and other illnesses related to exposure, and many others will develop mesothelioma and other forms of lung cancer. Given the wave of company bankruptcies, some argue that steps should be taken now to compensate these claimants before they are closed out of just compensation by the bankruptcy process.

**Defendant Reactions**

Meanwhile, the success that plaintiffs’ attorneys have had in recent years continues to fuel the growth in claims for less serious injuries. The increased costs that result have hardened defendants’ attitudes toward the problem. Many see claims coming from operations that were closed down decades ago, or through subsidiaries acquired long ago through mergers or acquisitions. Newer defendants are now seeing thousands of claims reported where once there were none. They argue that the increase in claims is forcing them to settle less meritorious claims at high amounts and that the money is going to the wrong parties—non-impaired claimants and their attorneys—with only about 25 percent of the settlement dollars going to truly sick people.

Many defendants have adopted a new, get-tough approach to the problem and are implementing litigation strategies to aggressively defend claims. These defendants talk openly about defense strategies that require proof of claimant impairment before claims are paid, the use of the insured’s internal records to show that the company’s products were not involved, and settlement of difficult cases before they have time to fester.

Many defendants and their insurers believe that they have now turned the corner and that these new practices will both control the costs of asbestos liabilities and protect them from shareholder suits. They concede, however, that their confidence stems from their faith in the new strategies they’re adopting, which have yet to affect paid claim figures.

**Accrual Issues**

Defendants and their insurers also are getting more serious about how they deal with these issues in their financial statements. Many are hiring experts to help them estimate future liabilities for asbestos claims. Chief financial officers at companies are routinely discussing with their accountants how these liabilities should be booked for GAAP purposes.

FASB 5 is the basic accounting rule that governs when an accrual for a liability must be posted. For that posting to take place, the event leading up to the liability must have occurred
The sheer weight of asbestos liabilities has driven more and more companies into the black hole of bankruptcy, illustrating the same principle that Newton observed when he watched an apple fall from a tree.

and the loss from the event must be reasonably estimable. However, the “reasonably estimable” portion of this rule is subject to differing interpretation.

For example, in recent years, actual booked asbestos payments contemplate widely varying time horizons, from one to 50 years, and may not be consistent with the number of years used in company scenario analyses. Most of the disclosures that cite the accrual period note that the period of funding is consistent with management’s comfort about how many years are estimable. Alternatively, some companies tell their experts the period over which they’re comfortable in having projections made for them, and the experts’ projections are formulated to contemplate only management’s selected time frame.

Ordinarily, non-asbestos-related casualty claims can be expected to be reasonably predictable from year to year. Using the historical experience of a defendant company, insurer or reinsurer, or industrywide statistics, it’s possible to project an expected reporting pattern for claims costs. Fixed blocks of similar claims occurring in a fixed period (e.g., auto liability claims occurring over 12 months) can be expected to follow such a reasonably estimable reporting pattern.

Unfortunately, this process is generally most useful in situations where new claims occur every year and the reporting and adjudication of claims are fairly independent. Asbestos is different. Claim settlements involve multiple claimants, and the same claimants will sue many different companies. Also, many of the law firms involved represent multiple cases.

The very definition of the term “occurrence” is difficult to apply to asbestos claims, given the long latency period associated with asbestos-related illnesses, which can take as long as 40 years to manifest themselves. Most of the claims currently reported are from people who were exposed to asbestos decades ago. These claims are now coming to light and being settled for many reasons, including the long latency period, the aggressiveness of counsel in seeking out victims, greater public awareness of the issue, company bankruptcies, and the economic environment.

Further, as prior manufacturers use up their insurance and go into bankruptcy court, which shields them from further large payments, new defendants are named by plaintiff attorneys. Thus, we have a situation where it is harder to use past reporting patterns to estimate liabilities. To deal with these issues, several accrual methodologies have been developed.

**Financial Statement Disclosures**

For many asbestos defendants and their insurers, legacy asbestos liabilities are extensive enough to warrant significant disclosure in the financial statements they file with the Securities and Exchange Commission. Many companies are also expanding their disclosures to shareholders to give investors more details on these activities than previously provided. These disclosures often run for pages and are interspersed throughout the financial statements. Common disclosures include information related to:

- Products and subsidiaries that have an exposure to asbestos claims;
- Historical payments and current funding accruals;
- Whether a consultant has been retained to estimate the unreported liability;
- How much of the liability is expected to be covered by insurance and credit issues relating to this coverage;
- Method of projecting future liabilities;
- Plan of restructuring if in bankruptcy.

Some of the disclosures take care to describe the methodology their consultants used to project liabilities. For example, one defendant’s disclosure named its consultant, disclosed that the projection involved claim activity through 2052, and gave the range of outcomes. Similar disclosures for other companies describe the process as well, although not always as explicitly.

Even when all of these issues are addressed, disclosures of accounting treatment and methodologies vary greatly. For example, while many companies disclose on their 10K filings that they have retained a consultant to estimate their ultimate liability for unpaid asbestos claims, not all book the consultant’s projections. Some companies do and clearly state that they do (or at least book within the consultant’s range). Others book differing amounts.

For example, several disclosures state that the consultant’s methodology involves projecting company asbestos claim activity through 2052. However, most companies accrued only the period in which management believes credible projections can be made.

One company, for example, discloses that it's booking on a 10-year rolling basis, presumably adding another year to the funding every year. This company further notes that management doesn’t believe these costs are reasonably estimable after 10 years. Another company discloses a 10-year accrual horizon without noting the rolling nature of the accrual. Some companies use a five-year horizon or some other time frame.

In their disclosures, companies typically go to great lengths to describe the inherent uncertainty in projecting asbestos claim liabilities. In several cases, companies disclose the existence of a separate consultant to work on the amount of insurance recovery expected to be available to pay the projected liability. Some companies disclose the use of multiple consultants. The company's
ability to collect the insurance is often discussed as well.

Some disclosures discuss the uncertainties that surround the liability estimation process, including uncertainties surrounding the types of claims, the latency period, differences in the legal environment between jurisdictions, the impact of bankruptcies, and the impact of potential tort reform.

The Everest Re disclosure cites no fewer than 18 areas of uncertainty relating to asbestos claims, including:
- continued growth in the number of claims filed;
- a disproportionate percentage of claims filed by individuals with no functional injury from asbestos;
- the growth in the number and significance of bankruptcy filings by companies as a result of asbestos claims;
- the growth in claim filings against defendants formerly regarded as “peripheral”;
- the concentration of claims in a small number of states that favor plaintiffs;
- the growth in the number of claims that might affect the general liability portion of insurance policies rather than the product liability portion;
- actions that specific courts have adopted to ameliorate the worst procedural abuses;
- an increase in settlement values paid to asbestos claimants;
- the potential that the U.S. Congress or state legislatures may adopt legislation to address asbestos litigation issues.

Litigation Costs
Most of the disclosures provide details on paid and accrued liabilities for several years. Others provide details on the number of claims and claimants. Interestingly, however, most of the disclosures are silent about whether the legal costs of settling asbestos expenses are funded on the same basis as expected indemnity costs. The author’s experience is that many companies treat these legal expenses as period costs, even though legal expenses in asbestos cases can be as high as 100 percent of indemnity costs.

For guidance, many accountants refer to American Institute of Certified Public Accountants Statement of Position 96-1, Environmental Remediation Liabilities (1996), which does not deal specifically with asbestos but is sometimes considered the closest relevant guidance. SOP 96-1 acknowledges that the treatment of litigation costs varies from company to company and that many, if not most, companies treat these expenses as period costs. It further states that the Accounting Standards Executive Committee of the AICPA does not provide guidance on the accounting treatment of such costs.

Principia Asbestos: Where Will It End?
In an article on the asbestos crisis published in CrossCurrents four years ago (“Asbestos: The Never-Ending Nightmare,” Summer 2001), we noted that the insurance industry had to come to grips with the need for another round of reserve increases for asbestos liability, given the likelihood of additional bankruptcies and attempts to bring in new defendants with deeper pockets.

Unfortunately for all parties involved, this has proved to be exactly the case over the past three years. The sheer weight of asbestos liabilities has driven more and more companies into the black hole of bankruptcy, illustrating the same principle that Newton observed when he watched an apple fall from a tree. And while many insurers have implemented massive reserve increases, rating agencies continue to regard the industry as severely underreserved for asbestos liabilities.

Our view today is the same. Higher reserve accruals are almost certain in the future for both defendants and their insurers, given the flood of company bankruptcies, the short funding periods of many asbestos defendants, and the lack of tort reforms. As a result, defendants will be under even more pressure to litigate coverage under their general liability policies.

If they succeed, we can expect additional insurance losses from this extremely difficult area of liability. And this situation will likely be further exacerbated by additional bankruptcies, spurring attorneys to look for new defendants. In short, the vicious cycle seen in recent years will continue, in a pattern as predictable as Newton’s laws of motion.

ORIN M. LINDEN is a partner in the insurance and actuarial advisory services practice of Ernst & Young in New York City. Christopher Diamantoukos, a senior manager in that practice, assisted in the preparation of this article. Nothing in this article is meant to opine on the merits of the claims of any asbestos plaintiffs, their law firms, or their right to compensation under any legal arguments. Nor does the author take any position on the merits of asbestos liability litigation or insurance coverage defenses. The sole purpose of the article is to discuss the current asbestos liability environment and explore some of its repercussions.