

Assessing the Merits of Reallocation

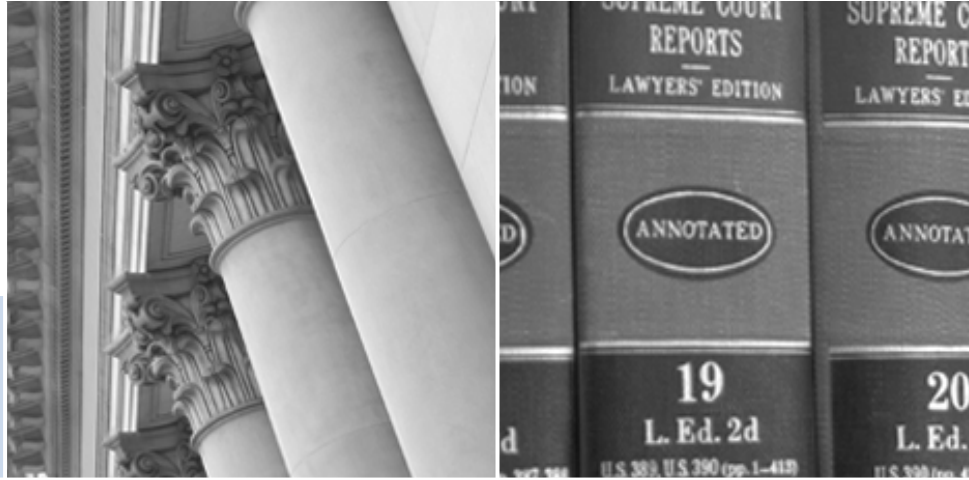
Presentation to American Enterprise Institute

By Anup Malani and Charles Mullin

April 21, 2005

Agenda

- Review legal concepts
 - Several liability
 - Joint and several liability
 - Reallocation
- Examine an asbestos case study
- Discuss policy implications



Legal concepts

Several liability

- D_1 and D_2 are liable to P for \$1 each
- Solvent defendants
 - Assets
 - D_1 has \$10.00 in assets
 - D_2 has \$10.00 in assets
 - Outcome
 - P recovers \$2.00
 - P sues D_1 and recovers \$1.00
 - P sues D_2 and recovers \$1.00
 - D_1 remains solvent
 - D_2 remains solvent
- Financially distressed defendants
 - Assets
 - D_1 has \$0.50 in assets
 - D_2 has \$1.25 in assets
 - Outcome
 - P recovers \$1.50
 - P sues D_1 and recovers \$0.50
 - P sues D_2 and recovers \$1.00
 - D_1 goes bankrupt
 - D_2 remains solvent

Joint and several liability with reallocation

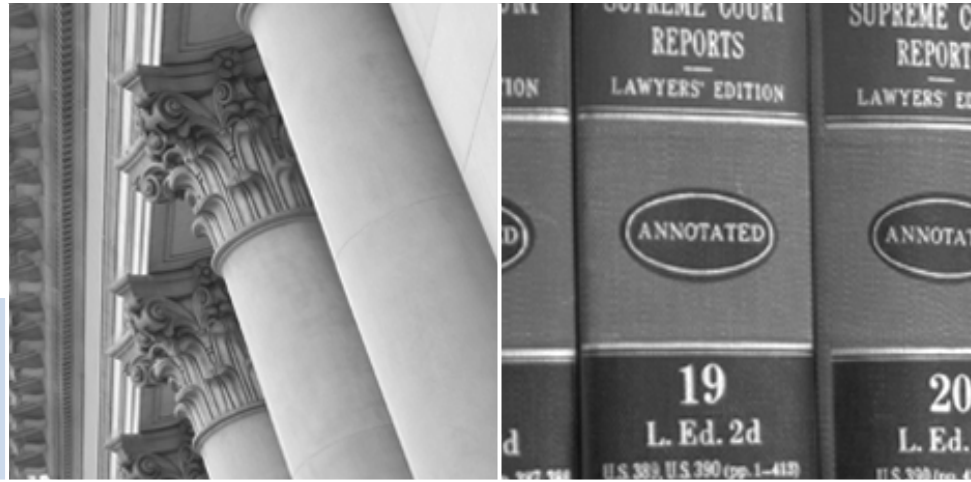
- D_1 and D_2 are liable to P for \$1 each
- Solvent defendants
 - Assets
 - D_1 has \$10.00 in assets
 - D_2 has \$10.00 in assets
 - Outcome
 - P recovers \$2.00
 - P sues D_1 and recovers \$2.00
 - D_1 sues D_2 and recovers \$1.00
 - D_1 remains solvent
 - D_2 remains solvent
- Financially distressed defendants
 - Assets
 - D_1 has \$0.50 in assets
 - D_2 has \$1.25 in assets
 - Outcome
 - P recovers \$1.75
 - P sues D_1 and recovers \$0.50
 - P sues D_2 and recovers \$1.25
 - D_1 goes bankrupt
 - D_2 goes bankrupt

Joint and several liability without reallocation

- D_1 and D_2 are liable to P for \$1 each
- Solvent defendants
 - Assets
 - D_1 has \$10.00 in assets
 - D_2 has \$10.00 in assets
 - Outcome
 - P recovers \$2.00
 - P sues D_1 and recovers \$2.00
 - D_1 sues D_2 and recovers \$1.00
 - D_1 remains solvent
 - D_2 remains solvent
- Financially distressed defendants
 - Assets
 - D_1 has \$0.50 in assets
 - D_2 has \$1.25 in assets
 - Outcome
 - P recovers **\$1.50**
 - P sues D_1 and recovers \$0.50
 - P sues D_2 and recovers **\$1.00**
 - D_1 goes bankrupt
 - **D_2 remains solvent**

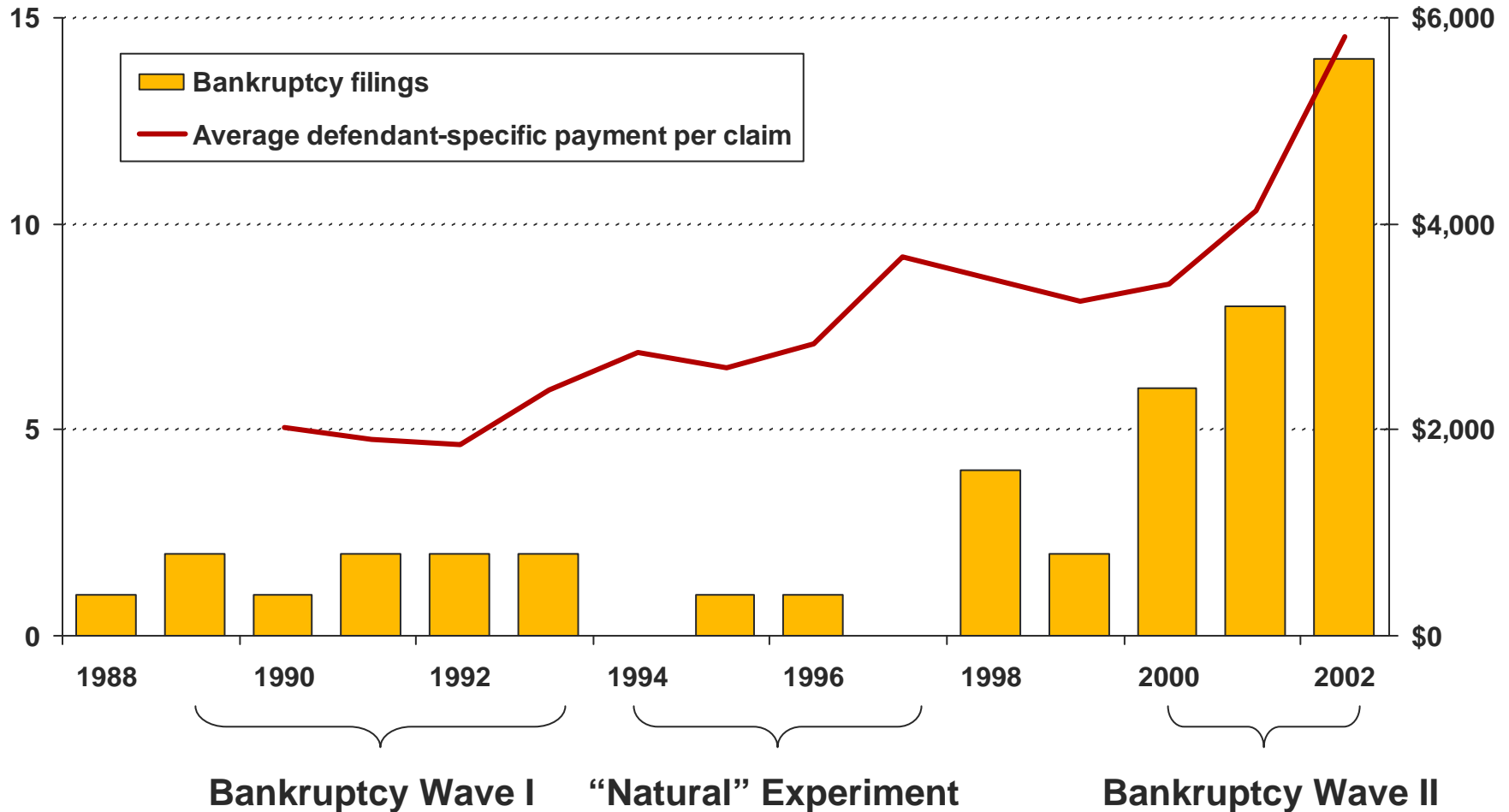
Benefits and costs of reallocation

- Benefits
 - Insure plaintiff recovery against defendant insolvency
 - Deter torts, get co-defendants to monitor
- Costs
 - Raises costs associated with bankruptcy of co-defendants
- We find that each additional \$1.00 of recovery from reallocation costs \$0.23 to \$0.66 in asbestos-related bankruptcy expenses



Asbestos case study

Reallocation of asbestos-liabilities has bankrupt numerous firms



The two bankruptcy waves contain most remaining asbestos manufacturers and installers

Bankruptcy wave	Companies	
Wave I (1989–1993)	Raybestos Celotex (Carey Canada) National Gypsum	Eagle Picher Industries Keene Corporation
Wave II (2000–2002)	Armstrong World Industries Babcock & Wilcox GAF Corporation Owens Corning/Fibreboard Pittsburgh Corning Federal Modul	USG W.R. Grace AC&S Harbison Walker Refractory Co. Kaiser Aluminum & Chemical Co. North American Refractories

Explanations for growth in defendant-specific payments

- Natural growth
 - Discovery of new evidence
 - Changes in liability rules
 - Evolving litigation strategy
 - Growth in wages
- Reallocation of payments
 - Co-defendant bankruptcies

Identification strategy

- Defendant-specific growth = reallocation growth * natural growth
- Identification of reallocation growth
 - Estimate defendant-specific growth from firm-specific settlement data
 - Estimate bounds on the natural growth rate
 - Use the above relationship to identify bounds on reallocation growth

Defendant-specific growth—estimators

- Data from 10-K filings
 - Aggregate asbestos-related expenditures
 - Number of asbestos claims resolved
 - Available for large and relatively mature asbestos defendants
 - Compute the annual growth in average settlement payments
- 689 litigation judgments between 1994 and 1998 (RAND)
 - Compute the annual growth in average judgments

Natural growth—estimators

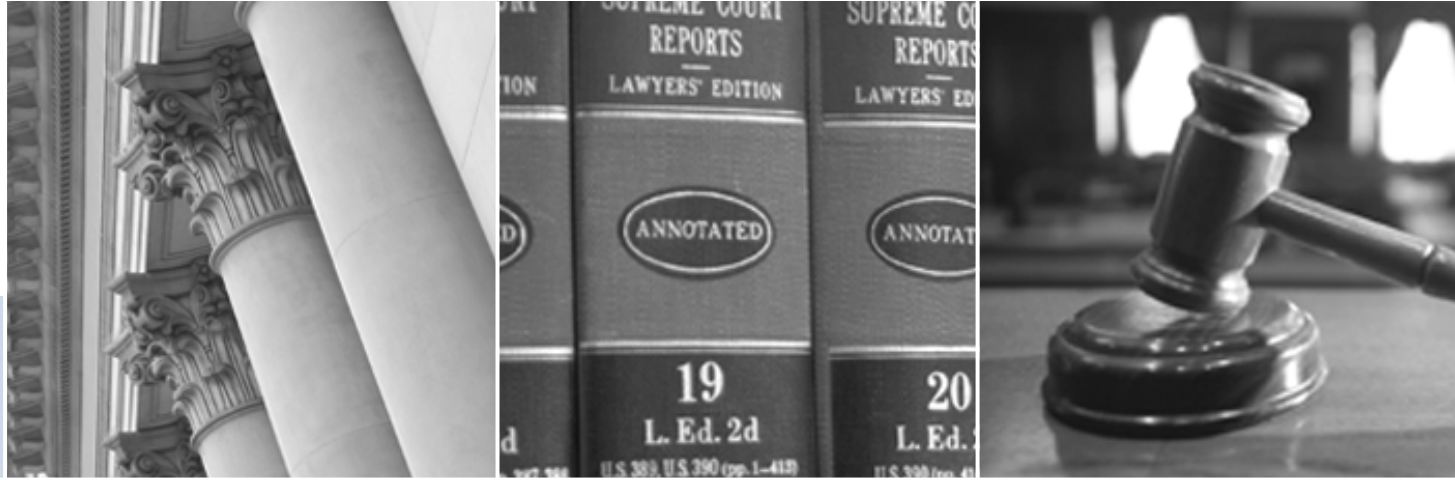
- Reallocation does not affect sum of payments across defendants
 - Growth in total average payments in 10-K sample
 - Assumes every plaintiff names each 10-K sample defendant
 - Growth in average payment per resolved claim within the 10-K sample
 - Allows for plaintiffs to name more defendants through time
 - Both estimators provide lower bounds on natural growth
- No growth due to reallocation when there are no bankruptcies
 - No significant asbestos bankruptcies from 1994 to 1997
 - *Georgine* class action was certified in 1993 and dissolved in 1997
 - *Georgine* distortions result in estimator being an upper bound

Reallocation caused at least 56 to 157 percent growth in defendant-specific claim value

Technique	Natural growth		Reallocation growth (real)		
	Nominal	Real	Wave 1	Wave 2	Combined
Aggregate payment	2.9%	0.2%	62%	59%	157%
Average claim value	0.0%	-2.7%	75%	72%	200%
“Natural” experiment	8.5%	6.1%	26%	24%	56%

Each reallocated dollar of compensation costs between 23 and 66 cents in bankruptcy-related expenses

- \$6.5 to \$11 billion in reallocated plaintiff compensation
 - \$53.3 billion paid from 1994 to 2002 (Tillinghast-Towers Perrin)
 - 36 to 61 percent reallocated payments
 - Two thirds of payments consumed by legal expenses
- Wave II bankruptcies cost between \$2.6 and \$4.3 billion
 - Social loss is 12 to 20 percent of pre-distressed company value
 - Aggregate enterprise value of Wave II companies was \$21.5 billion



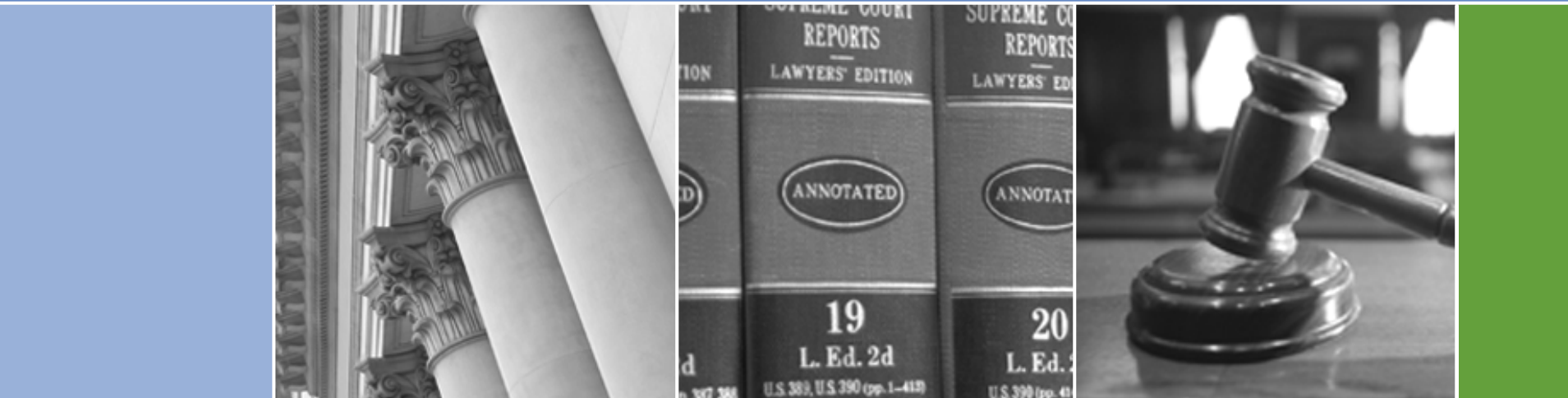
Policy implications

Alternatives to reallocation

- Reallocation is expensive insurance—23 to 66 cents per dollar
- Alternatives to reallocation
 - Raise the priority of tort claimants in bankruptcy
 - Same priority as secured creditors
 - “Superpriority” over all other creditors
 - Eliminate corporate limited liability for tort claims
 - Require companies to purchase insolvency insurance for tort claims
 - Analyze whether bankruptcy courts have the authority to discharge tort liabilities

“Superpriority” and no reallocation

- Shifts onus from co-defendants to secured creditors
 - Monitor (deter) tortious behavior
 - Insure plaintiffs against bankruptcy
- Impacts
 - Benefits
 - Secured creditors are better risk-bearers
 - Eliminates bankruptcy contagion
 - Could lower the cost of capital
 - Costs
 - Secured creditors are worse monitors
 - Could raise cost of capital

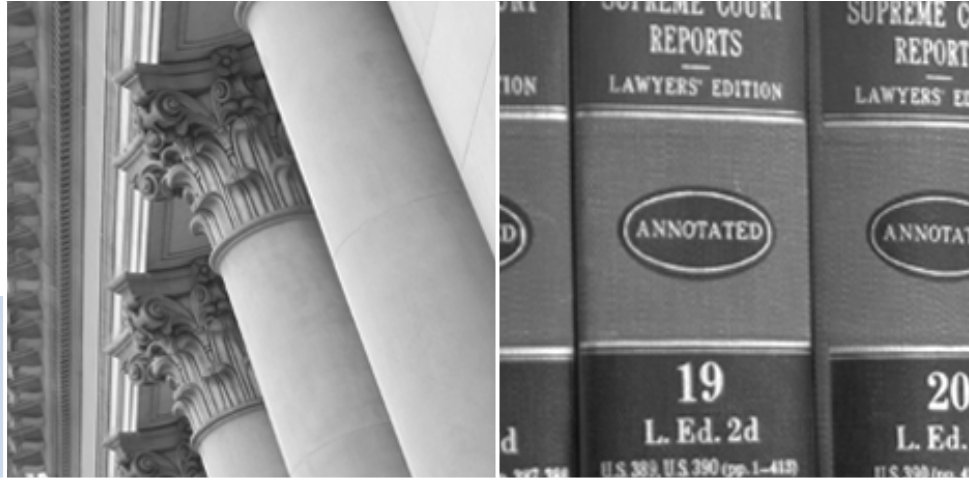


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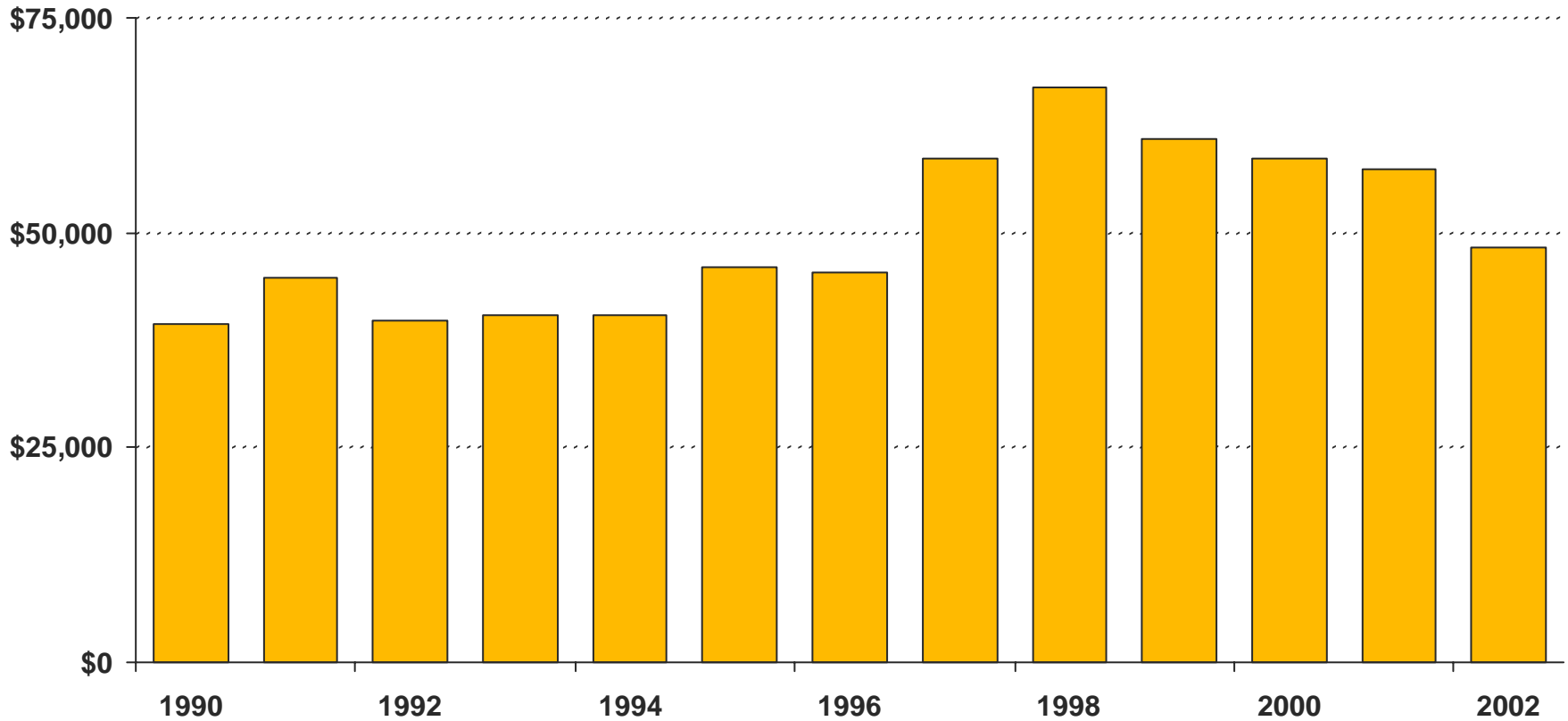
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Appendix

Sum of average payments within 10-K sample



Average payment per resolved claim within the 10-K sample

