Feature Article

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The Effect of Asbestos Litigation on the Valuation of a Business

Sometimes, very interesting and enlightening work is done as background or preliminary research on cases for which the expert is never retained. In the summer of 2001, our firm was contacted regarding our potential involvement in complex litigation involving a closely held firm that had been named in an asbestos liability lawsuit. Ultimately, our firm was not hired for the work. However, the initial work done to determine preliminary conclusions opened up a whole world that existed without our notice. Asbestos litigation long ago became a "cottage industry" and has decimated the value of individual companies and entire industries. By simply being party to (defendant) asbestos litigation, the market value of the target firm is decimated. The value of such a firm may never recover.

There is a semantic nuance that should be explained. The subject of this article is not the effect on a business of choosing to either manufacture asbestos products or include asbestos and its derivatives in its finished goods. The courts are working that issue out. This article is a study of the valuation effects of the resulting and related litigation; specifically, the effect of the asbestos litigation on the value of a business and the impact of looming litigation on the work and opinion of the valuation expert.

Asbestos litigation is illustrative of any major civil litigation threat. It is now the longest running mass tort litigation in U.S. history.[1] While asbestos litigation is common, it is not the only tort litigation wreaking havoc on the value of businesses in certain high-risk industries. Additional hazardous materials are emerging as subject of mass civil litigation. The experience with asbestos serves as both an illustration of the perils of such litigation and illumination of what can be expected in the future.

The fair market value of a business entity is as dynamic as the human psyche and the evening news. A business with tremendous market value may be the victim of bad publicity and, as a result, see its market value slip or disappear in a matter of hours. The value can "return" in an equally breathtaking amount of

time. Conversely, the markets have been successfully manipulated to artificially inflate market value. Law enforcement, specifically the Securities and Exchange Commission, is stepping up investigations and prosecutions of market manipulation that result in stock prices being temporarily and artificially inflated. Prices artificially overstated and understated illustrate the role of external valuation influences, and it is possible to see the stock price of a publicly held stock fluctuate materially when absolutely nothing in the underlying business has changed. It happens all the time. At some point during the fluctuation, the price does represent the accurate value of the business. At all other points, the market data is "inaccurate." The job of the valuation expert is to determine what the "real" value is. As will be shown, asbestos litigation causes tremendous stock value fluctuation (decreases) even as the underlying operation—the core business—increases profitability, market share, and value.

Significant external events within the industry or economy can greatly impact the value of a firm while nothing positive or adverse has occurred within the firm. A tragic example is a plane crash. The demise of several hundred people from the crash of an airplane in the fleet of one company can almost instantly affect the market value of the entire industry even as those companies are announcing increased profits, dividends, and market share. Other significant factors can be civil unrest, fluctuation in international monetary values, legislation, international political instability, etc.

When a firm is named in civil tort litigation, the valuation expert as well as the stockholders must consider the effect of that litigation on the market value of the firm. Our research has shown that asbestos litigation, in particular, is devastating to the value of a firm. All of the major asbestos defendants are likely to be in bankruptcy within 24 months.[2] Additionally, it is estimated that all of the claims that have been filed to date represent less than half of the claims that will eventually be filed.[3] It is a fair guess, therefore, that many valuation experts have been and will be confronted by the impact of asbestos litigation on the value of estates, ESOPs, buy-sell agreements, succession planning, etc. The valuation expert will be forced to account for that impact.

Because of its fire-retardant capabilities, asbestos was widely used in the manufacturing, construction, and shipbuilding industries until the early 1970s. Between 1940 and 1979, it is estimated that 27 million people in the United States were exposed to asbestos through their work.[4] Asbestos was later identified as the cause of the deadly cancer mesothelioma and several other forms of nonmalignant cancer as well as the disease asbestosis. The first asbestos litigation was filed in the 1980s and the claims for damages continued at an increasing rate through the 1990s.

There are two significant factors that cause the asbestos litigation to affect the value of the target company. First is the cost of either fighting the litigation, settling the cases, or both. Second is the impact of jury awards that exceed insurance coverage to such an extent that the verdicts bankrupt the company.

To study the business valuation impact of asbestos litigation, several public companies subject to asbestos litigation were chosen for analysis. Each company had different types of liability associated with asbestos, but all stand to pay material amounts for claims, and all theoretically base their expectations for long-term viability on the favorable outcome of the litigation. Most valuation experts would never use a public company as a guideline or comparative company when valuing a closely held business. In evaluating the impact of asbestos litigation, there is every reason to make the comparison and conclude that the experience of publicly held companies mirrors the experience of smaller firms and portends the future for firms of any size. The following is a description of three representative and well-known firms.

Federal-Mogul

Federal-Mogul (NYSE: FMO) manufactures and distributes precision parts for cars, trucks, farm equipment, and industrial products. In 1998 Federal Mogul acquired all of the stock of T&N, plc, a U.K. company that at one time had been a producer of asbestos and asbestos-containing products. When T&N was acquired, it no longer manufactured these products. However, in anticipation of asbestos litigation related to the acquisition, Federal Mogul set up a reserve of $2.1 billion (including insurance). The stock price at the time of the acquisition hovered at around $50 per share. Within a month after the acquisition, the stock price had risen 20% and fluctuated around $60 per share.

However, from 1998 through the end of 2001, Federal Mogul will have paid out over $968 million in asbestos-related claims and legal fees.[5] Through 2000, $618 million had been disbursed for litigation costs and liability. And the claims keep pouring in—the company currently has 365,000 pending asbestos claims.

While the stock had drifted as low as $.45 per share (the day it announced the Chapter 11 bankruptcy filing), it had stabilized around $1 per share by the end of November 2001. Clearly, the market value had all but disappeared.

Since the company does not manufacture asbestos and hasn't for years, the crash of the stock price cannot be attributed to continuing operations or adverse economic environment. The litigation the company knew it was acquiring ended up devastating the market value of the firm.

Owens Corning

On October 11, 2000, Owens Corning (NYSE: OWC) filed a petition for reorganization under Chapter 11 bankruptcy protection. The sole stated reason was the growing cash flow demands caused by its multi-billion dollar asbestos-related liability and associated costs. Within five days of the announcement, the stock price had fallen from $2.25 per share to $.75 per share. The stock price since has fluctuated between $1 and $2 per share.

The company has been involved in asbestos-related litigation for over two decades. The litigation did not materially or negatively impact the stock price, except to the extent of reduced earnings, until late 1998 when the stock price was in the $40 per share range. In December, 1998, the company announced that it was settling most of its pending asbestos cases (176,000). The move was made by the company in order to "remove investor uncertainty about the nation's largest maker of building insulation."[6]

However, the settlement did not stop new lawsuits from being filed. In 1999 thousands of additional cases were settled while still more were filed. From mid-1999, the share price was in steady decline. By the date of the bankruptcy filing, the company had received more than 460,000 claims and had agreed to pay $5.2 billion to settle 320,000 cases. In the firm's own public disclosures, the downturn in the economy beginning in 2000 was described as the last straw. Current earnings from operations were insufficient to continue financing the asbestos-related costs.

While the filing of civil lawsuits initially had little effect on the market value of the firm, by early 1999 the mere fact of additional filings put the stock in a permanent downward spin.

USG Corporation

United States Gypsum Company (NYSE: USG), through its subsidiaries, is a manufacturer and distributor of building materials producing a wide range of products for use in new residential, non-residential, and repair/remodel construction, as well as products used in certain industrial processes. The stock of USG is trading under $5 per share. This is down from its stock price ranging between $200 and $300 per share in the early 1990s.

On June 25, 2001, the company filed for bankruptcy protection under Chapter 11 and the stock price closed that day at $3.73 per share. According to data on the company's web site (www.usg.com), the filing was "to resolve asbestos lawsuits equitably" and to "protect the long term value of our business. Lawsuits continue to be filed at a high rate with no slowdown in sight."

In looking at the history of USG stock, it is evident that the market had already adjusted to the negative impact of impending civil litigation related to asbestos. Well before the bankruptcy filing, the market price for USG stock had fallen to the $5 per share range. The cause of the decline in market valuation can be largely isolated to asbestos litigation. A press release from the company on the day of the bankruptcy filing included the following assessment of current operations by William C. Foote, Chairman, President, and CEO:

"Our businesses continue to grow, and we remain the leader in our markets. Today's filing is not about restructuring our Company's operating units or dealing with a liquidity crisis. Rather, the Chapter 11 process ***was the only alternative to prevent the value drain*** *that has been occurring as U.S. Gypsum was forced to pay for the asbestos costs of other companies that have already filed for Chapter 11. The bankruptcy filing includes USG and its other major domestic subsidiaries to address financing needs during the Chapter 11 process and so that all USG companies would be included in the final resolution of U.S. Gypsum's asbestos liability. We carefully considered other alternatives. Chapter 11 is the only way to obtain a fair valuation of U.S. Gypsum's asbestos liability—**and it is the best way to preserve value for all of our stakeholders, including our legitimate creditors, our shareholders, and our employees."***(Emphasis added)*[7]

Conclusions

The impact of asbestos litigation on the economy and specific industries is still unknown in its totality and will be debated for years to come. The methods and novel attempts by several companies to resolve the litigation goes beyond the scope of this article but will be the subject of study and analysis as the debate rages on.

The effect on individual companies, however, is undeniable and consistent. The trend is now clear that pending litigation dramatically and negatively impacts market value. The lesson for the valuation expert is that pending asbestos-related litigation, regardless of the perceived loss probabilities, should result in deep discounting of market value. This appears to be true even when the defendant company is highly profitable, efficiently managed, and an industry leader. There appears to be no end to new cases being filed. Insurance coverage has long proved to be inadequate. Unless massive cash reserves are in place, future earnings will be committed to the costs of the litigation and the resulting liability awards. Valuation experts must also consider the similar effects of other environmental and chemical liability cases on the value of a business.

1 *Morningstar.com, "Asbestos: Over 500,000 Claims and $21 Billion and Counting," Aug. 15, 2001.*

2 *The RAND Institute For Civil Justice, "Asbestos Litigation in the US: A New Look at an Old Issue," prepared for meetings with the staff of the Senate Judiciary Committee and the House Judiciary Committee.*

3 *Ibid.*

4 *Forbes.com/Reuters, "U.S. Asbestos Litigation Net Spreading," August 15, 2001*

5 *"Asbestos Suits Hurt Fed-Mogul," Joe Miller; The Detroit News, October 2, 2001.*

6 *"Owens Corning Settling Most of its Asbestos Cases," by David Cay Johnston, NY Times, Dec.16, 1998.*

7 *USG press release, Chicago, Illinois; June 25, 2001*

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