New Market Emerges for Legacy Liability Dispositions

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Key Points

- A fast-growing market has emerged from the need by corporations to transfer uncertain legacy liabilities (such as asbestos-related claims and environmental clean-up costs) to financial sponsor-backed vehicles and insurance run-off houses.
- Acquirers of such liabilities include corporate providers, who represent the most novel and fastest-growing segment of the market.
- Separating the liabilities from the disposing group's existing assets is often the most complex aspect of these transactions.
- But competition for such deals from acquirers is fierce, and the market is expected to continue to flourish.

A substantial number of U.S. and overseas corporations have legacy liabilities that are complicating their equity outlook due to their uncertainty and duration. Typical examples are liabilities derived from asbestos-related claims or environmental clean-up costs.

Alternative asset managers have long been looking for ways to build up pools of captive capital that they can deploy into their strategies. Acquiring these long-duration liabilities along with the assets that back them represents an innovative and attractive way to grow assets under management as well as offer an opportunity to make a profit from the run-off.

As a result, a new market has emerged to assume and run off such liabilities on a noninsured, solvent basis. Meanwhile, there is increased insurer appetite for them.

Exiting such liabilities successfully requires the deployment of complex legal techniques as well as knowledgeable tax advice.

Who Is Transferring These Liabilities?

The typical transferor of legacy liabilities is a publicly traded or privately owned corporation. For public companies, the liabilities may be causing the company's stock to trade at a significantly lower price than it otherwise would, with the market often assessing the liabilities with considerable caution due to uncertainty around the amount and duration of them. There may even be doubts around the future solvency of the business.

Similar privately owned businesses likewise may find that such liabilities cannot be sold, either at an acceptable valuation or at all. The existence of the liabilities may also be locking up cash flows that might otherwise be returned to stockholders as dividends or in buybacks.

What Types of Liabilities Are Being Transferred?

Liabilities range from those that are well known and have been actively transferred for some years to those that have not yet been transferred (or only occasionally transferred). They include:

- Defined benefit pension plan liabilities.
- Self-insured commercial auto and workers' compensation liabilities.
- Asbestos-related claims.
- Industrial and military deafness claims.
- Sports-related head injury claims.

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- Environmental clean-up costs.
- Polyfluoroalkyl substance (PFAS) claims.
- Other claims, such as those relating to tall building flammable cladding, pharmaceuticals, talc and herbicides/pesticides.

Who Is Acquiring These Liabilities?

The acquirers of these liabilities typically fall into three categories:

- **Traditional insurers**, often based in the U.S., who provide a conventional insurance solution.
  - The constraints of insurance regulatory requirements ordinarily makes this the most expensive option.
  - There are multiple insurers that can provide solutions.
- **Legacy insurers**, usually based in Bermuda, who have established specific joint venture (JV) businesses for this purpose.
  - Though the legacy insurer will be managing the claims, a JV structure is necessary for the insurer to avoid the acquired liabilities from falling within the insurer's regulatory insurance consolidation group.
  - The JV is commonly structured with a financial sponsor or other private capital provider.
  - About a dozen legacy insurers offer this type of solution or insurance.
- **Corporate providers**, usually based in the U.S.
  - Corporate providers are typically backed by financial sponsors.
  - There are now about half a dozen corporate providers looking to acquire liabilities on a noninsured basis.
  - This is the most novel and fastest-growing segment of the legacy liabilities market.

How Are the Liabilities Separated Out and Acquired?

If an insurance policy is acquired to cover liabilities, implementation is straightforward: The company simply purchases the policy from the insurer, which then covers the liabilities over their remaining duration.

While an insured solution offers the protective benefits of insurance regulation, the company does not achieve finality, as it retains the primary exposure to the liabilities as well as credit and liquidity exposure to the insurance carrier. The company also retains the liabilities on its balance sheet over their remaining duration.

As discussed above, the alternative solution of a noninsured disposal of liabilities is offered by either legacy carriers through JV structures or pure corporate providers. Both adopt the same mechanics for acquiring the liabilities, so we will describe both simply as "providers" for this purpose.

The providers will typically acquire a corporate "box" containing the liabilities. The disposing group will transfer a negotiated amount of cash to the box. The benefit of existing insurance policies may also be transferred.

On acquisition, the provider will inject some funds itself, so that it, too, has "skin in the game." The provider will acquire the box for nominal consideration, *e.g.*, $1, and then run off the liabilities over their duration. The provider's profit comes from running off the liabilities for less than the value of the cash and assets in the box. In this context, "running off" the liabilities means gradually resolving each liability over time by litigation, settlement or by successfully resisting it.

The provider is not subject to insurance regulation, and the company achieves finality, as it does not retain the primary exposure to the liabilities and removes them from its balance sheet.

Separating the liabilities from the disposing group's existing assets is the most complex aspect of these transactions. There are various techniques available on the market.

- The simplest technique is to **sell the affected company in the group**, having topped up its funds if required, to avoid any later claim by creditors that the entity assuming the liabilities was insufficiently capitalized.
  - This assumes that no other members of the group have responsibility for the liabilities and that the company is not the parent.
  - It further assumes that the group does not want to retain the operating business within the affected company.
- Assuming that the liabilities are within a distinct subsidiary company or companies alone, the next available solution is for **the disposing group to set up a newco**.
  - The newco is then funded by the parent and uses those funds to acquire the operating business from the box on arm's length terms. An external adviser may provide a fairness opinion to back up the assessment of the newco.
  - The box is then topped up with funds and sold to the provider.
- **In many cases, the above solutions will not be available** due to the existing group structure or tax consequences. This could be because the liabilities sit in whole or in part in ongoing operating businesses, the parent company (as can be the case with long-established industrials) or because there are guarantee obligations.

- In this case, before the above solutions may be implemented, the disposing group will need to carefully extract its operations out of the entities that are subject to the liabilities, using techniques such as court-sanctioned demergers or holding company reorganizations.

There are potentially significant tax complexities in all the above mechanisms that need to be addressed. Separating operating assets from the entities legally responsible for any liabilities will likely require a detailed plan.

The optimal mechanism will focus on preserving the ability to deduct future amounts paid to creditors, plaintiffs or other claimants, as well as future costs and expenses such as legal fees incurred in connection with the liabilities.

These valuable tax deductions should be priced in connection with any negotiation with a provider; the allocation of the deductions between the disposing group and provider could influence the amount of cash and other assets that the two parties put into the box.

As part of the mechanism design and negotiation with the provider, the disposing group will also have to consider balance sheet consequences if these deductions are either lost or allocated to the provider, including the potential reversal of previously recorded deferred tax assets.

How Is the Disposing Group Protected Against Recourse?

The key pricing benefit for the providers is they are not subject to insurance (or any other form of) regulation because they are not providing an insured solution. This means they will not have to reserve in the way insurers do, so require less capital and have much greater freedom to invest their assets. Consequently, the pricing discussion with the provider typically starts with a conversation about the level of required generally accepted accounting principles (GAAP) reserving, which will usually be significantly less than the amount required to buy insurance.

While the pricing of a noninsured solution can be highly attractive, the nonregulated nature of the solution means the disposing entity will have to negotiate the disposition documentation carefully. Otherwise, it may risk recourse in the future if creditors allege that the disposing company designed a "fraudulent conveyance" of the liabilities.

A disposition can trigger such concerns if, for example, the provider was insufficiently capitalized, or the extraction of business operations was not on arm's length terms. Protections against these types of concerns include prescribing the provider's investment policy, adding restrictions on affiliate transactions and imposing a dividend prohibition following the liability acquisition.

Will This Market Continue To Grow?

The consummated transactions so far have demonstrated that a legacy disposition can yield considerable benefits. Competition for these deals from acquirers is fierce. Significant differences in valuation view between the legacy and corporate markets now exist, enabling the arbitrage of liabilities to specialist acquirers.

For these reasons, we expect this market to continue to flourish.

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