

# Liability Divestiture Transactions: A Win-Win for Financial Buyers and Mass Tort Defendants

Contributing Partners

**Michael J. Cardella** / Washington, D.C.

**James J. Mazza, Jr.** / Chicago

**Ann Beth Stebbins** / New York

## Key Points

- Companies with major contingent legacy liabilities such as mass tort exposure may want to consider a liability divestiture transaction, which isolates and transfers contingent liabilities to a third-party buyer.
- These transactions provide balance sheet certainty for divesting companies and investment opportunities for specialized financial buyers.
- Success depends on disciplined structuring and integrated tax, corporate and restructuring planning.

Several industrial companies have recently implemented transactions to permanently divest legacy contingent liabilities. In these transactions, the divesting company transfers ownership of an entity holding specified legacy liabilities to a third party, typically an institutionally capitalized entity with expertise in claims management.

Following the transfer, the third-party buyer is fully responsible for administering, defending and resolving claims arising out of the legacy liabilities.

The legacy divestiture transaction removes the contingent liabilities from the transferor's balance sheet, eliminating defense and settlement costs. For the third-party buyer, the transaction provides a source of investable capital and potential upside if investment returns exceed the buyer's cost of capital and liabilities are efficiently resolved.

Specific structures vary depending on the corporate organization of the divesting company and the characteristics of the liabilities. Most transactions completed to date have involved asbestos liabilities, which have a mature, and therefore relatively predictable, claims filing and resolution history.

These transactions share a core architecture that integrates corporate, tax, finance and solvency considerations and requires coordination among legal, actuarial, tax and financial advisers.

## Internal Restructuring

As an initial step, the divesting company must separate its assets and liabilities (including its operating businesses) from the specified contingent liabilities. These are allocated to one or more legally distinct entities (Liability Entities) that hold only legacy liabilities and related assets.

In recent transactions, the divesting company used the Delaware division statute to allocate assets and liabilities to one or more companies resulting from the division. Each of these companies must be solvent, taking into account financial support provided by other entities within the divesting company's corporate structure.

Tax-deferred treatment is typically sought for the internal restructuring steps, necessitating careful design and input from tax advisers. The internal restructuring steps must also be configured to comply with restrictions in the divesting company's debt documents and other commercial contracts.

When a parent entity is itself a tort-claim defendant, it may be necessary to reorganize the existing parent under a new holding company before allocating assets and liabilities to the Liability Entities. This may require shareholder approval and, in the case of a public company, registration of the new holding company shares.

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One Manhattan West  
New York, NY 10001  
212.735.3000

When the internal restructuring is completed, the Liability Entities hold only legacy liabilities and related assets, and possess sufficient liquid assets or funding rights to satisfy projected liabilities.

### External Disposition Transaction

After the internal restructuring is complete, the divesting company solicits bids from potential third-party buyers to acquire the Liability Entities. In evaluating bids, the divesting company will consider:

- The amount of liquid assets contributed to the Liability Entities by the buyer and seller.
- The investment restrictions applicable to those assets.
- The timing of and limitations on distributions out of the Liability Entities.
- Any additional financial support from the buyer.

Tax structuring also plays a critical role in the transaction, as structuring decisions can allocate beneficial tax attributes (*i.e.*, deductions for future payment of contingent liabilities) to either the buyer or the divesting company.

The divesting company generally aims to:

- Maximize the buyer's cash contributions and/or financial assurances, which may take the form of a guarantee or a keep well from a creditworthy entity.
- Minimize the cash the divesting company is required to contribute to the Liability Entity.

Meanwhile, buyers typically seek to maximize the cash contribution by the divesting company. This creates

a “reverse auction” dynamic, with the most attractive bidders requiring lower contributions from divesting companies, so long as the solvency of the Liability Entities is clear.

Buyers also seek to minimize restrictions on post-closing investments and distributions by the Liability Entities, while the divesting company focuses on ensuring that restrictions are in place for at least as long as look-back periods under fraudulent conveyance statutes.

The combined contributions of the divesting company and the buyer to the Liability Entities must be sufficient to establish solvency — as determined by an independent third-party expert — before and after closing. Restrictions on investments and distributions by the Liability Entities must be structured to minimize the risk of fraudulent conveyance claims following the closing.

Once final terms are agreed to, the divesting company transfers all of the equity interests in the Liability Entities to the buyer for nominal consideration. All intercompany financial support arrangements from entities within the divesting company's corporate family are terminated, and the Liability Entities are funded with liquid assets contributed by the buyer and the divesting company.

Thereafter, all claims arising out of the legacy liabilities are managed by the buyer and the Liability Entities, and the buyer directs the investment of the Liability Entities' funds in accordance with investment guidelines agreed to with the divesting company.

### Final Thoughts

A successful liability divestiture transaction provides a legally durable, efficient method for a company to remove the uncertainty of legacy contingent liabilities from its balance sheet, without a court process such as bankruptcy. Their effectiveness depends on precision in design, careful execution, attention to solvency projections and a multidisciplinary advisory team.

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