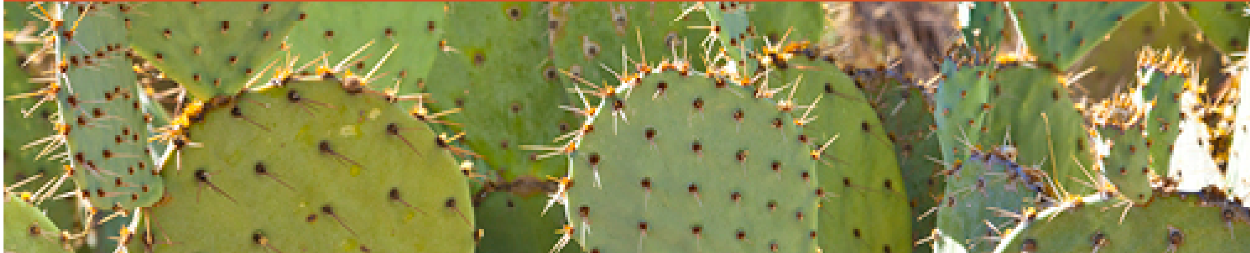
Insurance Coverage Litigation Committee CLE Seminar

March 5–7, 2015
Loews Ventana Canyon
Tucson, AZ



Belling the Cat – Berkshire Hathaway and the Collective Action Problem

Jonathan Terrell
President, KCIC
Washington, DC

The Collective Action Problem

> ***"Long ago, the mice had a general council to consider what measures they could take to outwit their common enemy, the cat … a young mouse proposed that a small bell be procured, and attached by a ribbon round the neck of the cat."***

The dynamics of asbestos litigation in the USA are on point with the Collective Action Problem as illustrated in the fable "The Bell and the Cat", often attributed to Aesop. The Collective Action Problem describes a situation where many parties would benefit from a course of action, but the cost or downside for any one individual is high. The rational course of action is for the parties to collaborate and undertake collective action and thereby share the cost or downside between them, but achieve the desired course of action.

While each state has its own rules, as a general proposition, a plaintiff may sue many defendants in seeking a remedy, and there is no presumption that the loser will pay the costs of the winner. There is, therefore, very little downside for a plaintiff to add additional companies to a complaint, so long as the plaintiff can satisfy the relevant federal or state rules of civil

procedure.[1] While plaintiffs' firms cannot sue companies willy-nilly without risking sanctions, as a practical matter it is not hard for plaintiffs to sue many companies and still satisfy the procedural rule.

This is a particularly American situation. By way of comparison, in England (and in most western democracies), an asbestos plaintiff may sue a single defendant for its entire damages. (The defendant company may itself seek "contribution" from other companies that share responsibility).[2] Normally, in England, the loser in litigation pays the attorneys fees and costs of the winner.

In the course of our consulting work, KCIC processes a large number of asbestos-related complaints/lawsuits. In 2014, KCIC processed more than 5,200 such lawsuits, which likely represents a significant percentage of the total number of asbestos claims filed in the United States, though it is impossible to completely and accurately establish the full population of lawsuits.[3]

On average there were 61 defendant companies named on each complaint processed by KCIC and there are more than 8,400 unique defendant companies named in total. While there may be some opportunity for consolidation where both a subsidiary and parent is named, for the most part every defendant company has to take action with the complaint. A service agent or the defendant must accept service of the complaint, counsel must be appointed to defend the complaint, a database of claim, claimant and lawsuit information and documentation must be maintained, defense costs collected, and defense and indemnity payments made.

This means that for just the complaints processed by KCIC in 2014, over 300,000 initial actions had to be taken, and most complaints required additional, perhaps many, actions.[4] Many complaints of course named far more defendant companies than the average, with 18% naming at least 100 defendant companies and one naming more than 300, requiring an incredible number of actions for just one complaint.

These are staggering statistics that represent a significant tax on corporate America. As a matter of fact and law, most of the companies' named on the complaint did not in any way contribute to the asbestos-related disease of the plaintiff. But they may be faced with a difficult choice –

[1] Federal Rule of Civil Procedure re Pleadings and Motions (Rule 11) has been widely adopted at the state level. The rule requires, inter alia, for the plaintiff lawyer to perform an inquiry reasonable under the circumstance, to have evidential support for the allegation, and to demonstrate objective good faith.

[2] Compensation Act 2006.

[3] As the Rand Institute for Civil Justice pointed out in its seminal 2005 monograph "Asbestos Litigation", there is no national registry of asbestos claimants, and most lawsuits are filed in state courts that do not routinely identify and report annual asbestos lawsuits filings. That monograph estimated 83,850 complaints in 2001. Since then there has been a very significant decrease in filling rates, especially for non-malignant injuries. Other commentators estimate that filling rates are currently running at about 20% of 2001 levels. (See "Snapshot of Recent Trends in Asbestos Litigation" NERA May 2014). Our dataset is, therefore, likely representative of the population.

[4] (5277 (number of complaints) x 61 (average number of companies named) = 321,897)

either pay some settlement dollars to get out of the case, or be prepared to go to trial to prove their defense.

We also observe the same phenomenon noted in the Rand monograph: that a very few national asbestos plaintiffs firms are responsible for the vast majority of the complaints. In our dataset, 20 national plaintiffs firms were responsible for 73% of the lawsuits, 10 were responsible for 58% of the lawsuits, and 5 were responsible for 41% of the lawsuits.[5]

So there we have it, the Collective Action Problem -- many different companies getting dragged into asbestos litigation by very few plaintiffs firms.

Going back to the fable, the plaintiffs bar is like the marauding cat, the defendant companies are the mice. "Belling the Cat" means going to trial when you have a reasonable defense. But like the mice in the fable, most defendant companies, most of the time, do not want to be the ones holding the bell and ribbon and having a close encounter with the jaw and claws of the cat.

There is a further dynamic to the Collective Action Problem – that of managing general-liability insurance. Attendees at the ABA Conference do not need much of an explanation here – but just to make the point: most defendant companies have historical occurrence-based general liability insurance, and most asbestos claims trigger many years of coverage. There are typically lots of different insurance companies represented, not just across the years, but within the insurance towers for each year. In the case of London-placed coverage, due to the subscription nature of that market, there may be dozens of risk-taking insurance entities behind a London program spanning several years.

The involvement of the various insurance companies in managing asbestos-related litigation varies according to the appetite of the company, whether it is primary or excess insurance, the relevant policy language, and the nature of any existing coverage agreements in place between policyholder and insurer. Asbestos-related indemnity and defense payments will typically be shared among several insurance companies, and there may well be significant involvement from them, or even control, over defense and settlement strategy. The decision as to whether to put the bell around the neck of the cat may be taken, therefore, by many more players than just the defendant companies, and there may well be disagreement not just between the defendant company and its insurers but among the insurers, too.

[5]The top five plaintiffs firms were: Law Offices of Peter G. Angelos P.C., Weitz& Luxenberg PC., Gori, Julian & Associates, P.C., Simmons Hanly Conroy, and Napoli Bern Ripka, Shkolnik, LLP.

Enter Berkshire Hathaway

Berkshire Hathaway has the largest concentration of asbestos liability in the insurance industry and in history. This was amassed through its own underwriting, from insurance companies that it has acquired, but most significantly, through a series of retroactive reinsurance deals with liability insurers seeking to off-load their asbestos coverage books of business. I wrote about this in a paper published for the 2014 ABA Conference "Berkshire Hathaway and Loss Portfolio Transfers: Do They Make Sense?".[6]

To get a sense of Berkshire's dominance of the domestic market, the A.M. Best Special Report "U.S. Insurers Continue Funding of A&E Liabilities Despite Elusive End Game", which analyzes the statutory filings of domestic issues, is instructive.[7] Exhibit 7 to that report ranks US Property and Casualty insurance groups by their asbestos and environmental reserves. Total reserves as of December 31, 2013 were $28.8 billion. Berkshire's reserves (before taking account of the retroactive reinsurance it has underwritten) were $2.4 billion But when you look through the table and note that AIG, CNA, Liberty Mutual and White Mountain are all retroactively reinsured into Berkshire, the size of their market presence becomes clearer.[8] Note 23 F(e) to the 2013 statutory filing for National Indemnity Company lists 34 entities retroactively reinsured into Berkshire (though not all of these are asbestos deals).[9]

The other significant market is London. As a result of Berkshire's retroactive reinsurance of Equitas and other company market participants, in my estimate, Berkshire has an even larger share of that market than it does of the US domestic market.

It is not simply a financial concentration of coverage responsibility. Berkshire typically insists on claims-handling control as a part of its retroactive reinsurance transactions. In all of these deals, for all intents and purposes, Berkshire stands in the claims-handling shoes of the underlying insurer with full powers to adjust claims as they see fit.

Many policyholders are concerned not just about the fact of the concentration of risk and decision making at Berkshire, but they have encountered significant changes in their claims-handling experience after Berkshire has taken over handling their account from the originally obligated insurer -- namely the reduction in coverage payments made by Berkshire as compared to those made by the original insurer. Berkshire addresses these charges directly, and through its

[6]http://www.americanbar.org/content/dam/aba/administrative/litigation/materials/2014_inscle_materials/written_materials/b14_3_berkshire_hathaway_and_loss_portfolio_transfers.authcheckdam.pdf.

[7] December 19, 2014.

[8] The relative rankings are Berkshire No. 2, AIG No.3, CNA No. 7, Liberty Mutual No. 9, and White Mountains No. 15.

[9] Berkshire Hathaway underwrites the majority of its retroactive reinsurance deals through its reinsurance subsidiary, National Indemnity Company.

defenders, by contending that it is a benefit to policyholders when it takes over claims handling for multiple insurers because such concentration of power will help solve the Collective Action Problem. In other words, Berkshire is taking credit for putting the bell around that damn cat's neck. And it must be admitted, there is a certain superficial appeal to what Berkshire is up to.

Bending the Cost Curve.

Defense Costs

Berkshire has described itself as the "Wal-Mart" of purchasing legal services for defense of asbestos claims. Its enormous market presence means that the majority of law firms specializing in the defense of asbestos claims, directly or indirectly, are dependent, to some significant extent, upon Berkshire for their work. Berkshire has its favored firms and likes to consolidate representation where possible. Defense firms, of course, owe their first allegiance to the defendant companies, but it may be very difficult for them to disregard the fact that they are being paid more money by Berkshire than anyone else. As the Wal-Mart of the defense bar, Berkshire is able to exploit this market power, and can negotiate --or even dictate -- lower reimbursement rates than anyone else.

Berkshire argues that this is all to the benefit of the defendant companies. The argument goes that the less money expended on defense costs the better, because that results in slower erosion of triggered insurance limits, and lower out-of-pocket costs to the defendant.

Belling the Cat

The next argument, and we really get to the heart of the matter here, is that with Berkshire's extreme market concentration, they are able to address the Collective Action Problem. They have the clout to put the bell on that cat. As a result of their market presence, they are financially responsible for many of, maybe most of, the companies named as defendants in that lawsuit (remember, our data reveals an average of 61 companies per lawsuit.) Even though most of the defendant-companies likely have strong defenses, most will chose to settle rather than incur the expense of litigating and the potentially disastrous consequences of an adverse verdict. But Berkshire argues that it is able to change that dynamic for the benefit of all defendants. Berkshire is prepared to take cases to trial, suffer losses on occasion, and continue on through the appellate process if needed. Berkshire argues that if it is able to stand up to the plaintiffs bar, and teach them an important lesson – that less meritorious claims will be contested aggressively and will not be settled or paid readily -- then the plaintiffs' counsel's fishing expeditions to trawl for compensation among many companies, most without any real nexus to the plaintiff, will have to stop.

No More Taking Advantage of the Innocent Insurance Industry

Berkshire's third main argument concerns the way defendant companies access their insurance assets. Berkshire accuses policyholder defendant companies of sometimes taking inconsistent positions with different insurers in their program to maximize their available coverage. Berkshire argues that, by standing in the shoes of all such insurers, it can put a stop to such strategies because they will uncover these inconsistent positions, and are, therefore, in a position to counter them.

Berkshire Hathaway's Solution: Smoke Screen to the Problem

While I would be the first to agree that there is a Collective Action Problem, the argument put forward by Berkshire to justify their actions in the asbestos claims handling context are flimsy at best. Rather than the mice putting a bell on that cat, this is more akin to putting a fox in charge of the hen house.

Who Do They Think They Are?

On the one hand, Berkshire likes to argue that its enormous market presence is simply the result of ordinary- course reinsurance arrangements, with some TPA claims-handling services thrown in, under which it is simply handling claims under the direction and control of the reinsured insurer. On the other hand, Berkshire applauds itself for solving the Collective Action Problem. One is reminded of the classic definition of "chutzpah", as the boy who murders his parents and then throws himself upon the mercy of the court because he is an orphan.

Congress has repeatedly turned its attention to the Collective Action Problem at the heart of the asbestos litigation business. The Supreme Court has grappled with the problem, and declined to act. The judicial and legislative branches of our government have been unable to solve this problem. Yet Berkshire, with no privity of contract to the policyholders under the insurance policies at issue, and with no standing in the mass tort litigation between plaintiffs and defendants, applauds itself for solving a problem that our government has been unable to address. And it comes to the table with its own set of motivations and incentives -- all of which are financial in nature --, and decidedly with unclean hands.

Asymmetric Risks

If Berkshire, in its judgment and using its newly amassed market power, pushes a defendant company policyholder to go to trial against an asbestos claimant rather than to pay a particular

settlement amount, and the defendant suffers a loss at trial, perhaps with a multi-million dollar verdict, the consequences for Berkshire and those for the defendant, are not aligned. The maximum loss for Berkshire is likely limited by the policy limits of the underlying insurance contracts reinsured into Berkshire, and ultimately by the limit of the retroactive reinsurance. The consequences for the defendant company that was pushed into trying a case it wished to settle, however, may be far more dire.

For example, a company that has previously managed to "stay under the radar" through a discreet settlement strategy, may now be subject to discovery that opens it up to previously contained liabilities. A headline, multi-million dollar verdict, may put a defendant on the map with the plaintiffs' bar in a way it never was before – thus becoming a target defendant in future cases. This may result in the defendant company incurring asbestos liabilities in amounts several times those estimated before the trial verdict, and bankruptcy may be that defendant's only option. Inexperienced claims adjusters pushing defendant companies to go to trial for the sake of advancing Berkshire's financial objectives, may do so with the security of limited downside risk to Berkshire, but often such strategy poses unlimited downsides for the defendant.

Given the stakes involved in asbestos litigation, it is not surprising that many defendant companies are extremely sensitive to the quality and experience of their defense lawyers, and not just to their respective billing rates. When going in for life-threatening surgery, you don't want the cheapest surgeon; you want the best. And when a company is embarking on "bet the company" litigation, it is not looking for cut-rate legal representation either. Thus, the Berkshire argument that forcing down rates of defense counsel, and hiring the least expensive defense counsel available is good for policyholders is overly simplistic and clearly not accurate.

The Not So Benign Dictator

One might be tempted to drink the Kool-Aid if convinced that Berkshire could attack the Collective Action Problem with pure motives, real expertise, and a market presence of sufficient size. Yet, that is simply not the case.

The reality is that Berkshire's lectures about the Collective Action Problem are no more than a "smoke screen" to justify a highly advantageous business practice in entering into retroactive reinsurance deals – generating and holding on to cheap sources of capital for the Berkshire's investment machine. I wrote about the Berkshire business model extensively in my paper "Berkshire Hathaway and Loss Portfolio Transfers: Do They Make Sense?", published last year in connection with this conference.

Therein I explore the enormous importance of "float", of which premiums from retroactive reinsurance transactions are an important element, to the Berkshire business model[10]. I point out that Berkshire and National Indemnity's investment strategy is unlike that of any other major Property & Casualty insurer, with a far higher concentration in equity positions in relatively few companies. And I point out that even though National Indemnity earned less than 1% of industry premiums it generated 26% of investment income in 2013. The balance sheet of National Indemnity more resembles that of a private equity fund than an insurance company.

I will not delve into the subject of Berkshire's claims handling competence here. But I will say, based on Berkshire's negative reputation for claims handling in the marketplace, that serious questions must be asked about Berkshire's competence and willingness to use its market power to solve the Collective Action Problem.

And finally, even though Berkshire's market presence is enormous, and unprecedented, it is still likely less than 50% of the total market. Berkshire is not therefore able to convincingly make the collective action argument at this point -- although its market share continues to grow with every new retroactive reinsurance deal it enters into. In many situations, Berkshire's share of a potential settlement may be dwarfed by the shares of other insurers and the insured combined. Consequently, their asserted position of resisting settlements with asbestos claimants and proceeding to trials is clearly untenable under any theory of collective action, and such position should be viewed for what it really is -- a diversion for the real motivations behind Berkshire's conduct .

> ***"The plan to attach a bell to the cat is applauded by all the mice, until one mouse asks who will volunteer to place the bell on the cat. All of them make excuses."***

Jonathan Terrell is the founder and President of KCIC, a consulting firm that focuses on providing quantitative, litigation and strategic consulting services to corporate policyholders and their legal counsel. He has decades of financial services experience gained in London, New York, Paris and Washington DC with a background that crosses accounting, finance, insurance and banking disciplines.

Mr. Terrell has made a special study of Berkshire Hathaway's involvement with Loss Portfolio Transfers, and has participated in ABA panels and roundtable discussions over the past few years. He has been retained as an expert witness in a number of cases concerning various aspects of these LPTs and in

[10] In the insurance bargain, a premium is typically paid up front, and sometime later, a claim may be made, and even paid. In the meantime, the insurer gets to invest the premium. This is what referred to as "float", the positive cash flow at the front end of the insurance bargain that insurers can invest.

addition is in demand for testimony concerning insurance company solvency, economic damages, and insurance asset valuation.

Before establishing KCIC, Mr. Terrell was an Executive Vice President with Zurich Financial Services, a Vice President in JP Morgan's Capital Strategy and Quantitative Analysis Group, and worked with major international clients at Price Waterhouse and Ernst & Young in the banking and insurance industries.