Insider Trading Teaching Case: Owens-Corning Fiberglas

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April, 2006

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Thanks to the following: the Lilly Fellows Program in Humanities and the Arts and the Xavier Jesuit Community for providing funds that helped with this project, Bob Ahuja, Dana Tindall for technological support that made it possible for more student involvement, Paul Fiorelli for organizing the Teaching Business Ethics Seminar in the Summer of 2005 that provided several good ideas, Marianne Jennings for useful resources and Debra Mooney for her encouragement and support.

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Abstract

This case illustrates a situation that could be faced by an employee with access to sensitive information about their company. The case provides information about what insider trading is and the legal ramifications involved. In addition it provides a good setting to discuss the meaning of accounting practices such as write-offs, market efficiency and how investors incorporate knowledge into stock prices. Although the case is set in 1992, the situation is timeless. Owens-Corning went through Chapter 11 in the 2000 so stock price information on Owens-Corning is difficult to obtain. Therefore, students do not have easy access to the end result of the case. The case is suitable for undergraduates and graduates.

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It is early February 1992. David is a junior accountant at Owens-Corning Fiberglas, a member of the Fortune 200. He is in his second year of a two-year financial development program which is rotating him through different finance projects before being assigned to a semi-permanent position. During one of his assignments last year he worked with the accounting department that prepared the annual report. As a member of this group he was listed on a company wide "blacklist" which prohibited individuals on the list from buying or selling Owens-Corning stock during certain times of the year such as several weeks before the annual report is published. He is no longer listed on the "blacklist".

David finishes up an assignment and decides to clean up some computer files. While doing so, he realizes that his access to the upcoming annual report information has not been turned off. David is a curious person and decides to read some of the information which will be published in less than one week.

While reading the annual report information David learns that Owens-Corning is going to report a net loss of $529 million including a $800 million write-off (non-cash charge) for asbestos liability. Last year Owens-Corning posted a net loss of $33 million which included a restructuring charge of $65 million. In addition David reads a press release which later becomes the news article shown in Table 3.

Owens-Corning Background [1]

Owens-Corning Fiberglas was a joint venture between Owens-Illinois and Corning Glass. The public first began publicly trading in 1952. The principal products were fiberglass insulation, shingles and fiberglass mat used in industrial and consumer applications.

One of the company's products prior to 1972 used asbestos as one of the raw materials. When asbestos was found to cause lung problems such as mesothelioma, asbestosis and cancer, they stopped using it. Although Owens-Corning did not produce a very large percentage of the market share of asbestos, in 1992 it was one of the few asbestos-related companies left in business that had deep enough pockets for lawyers to sue.

Lawyers would pull up to OCF fiberglass factories with x-ray machines. Anyone with any kind of lung spot (such as life-long smokers) would be added to class action lawsuits. In 1992 Owens-Corning had lost some major lawsuits. Some of them were rather frivolous including a $15 million award to someone because they were afraid of getting cancer. However, others had merit for workers suffering from mesotheliomia, a disease that makes it very difficult to breathe.

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[1] Some of the following material comes from the Owens-Corning Fiberglas website http://www.owenscorning.com. (November 2005)

Insider Trading Rules[2]

Illegal insider trading occurs when a person trades based on material nonpublic information, which is likely to be important to a reasonable investor. Examples include executives, large shareholders and employees who work on information for the company. The information belongs to the company and its shareholders. The person who obtains the information has a fiduciary duty to the company and its shareholders not to use the information.

Firm employees are also prohibited from providing information to a third party who is likely to use that information. If the third party who is provided information knew or should have known that employee was violating a fiduciary duty the third party is also liable for illegal insider trading. Third party members would include family members, friends, etc.

Third parties who provide services such as attorneys, tax accountants, and consultants have a duty to not trade or provide tips based on the information they are exposed to during the course of providing services.

Courts have ruled that even though companies do not have fiduciary duties to derivative security holders of the stock, it is illegal to use illegally obtained information in trading these types of securities.

Examples of Material Non Public Information include:

- Pending Acquisition or Divestiture that has not been announced
- Major Change in Dividend Policy
- A sharp decline or increase in the firm's projected earnings
- Significant unexpected losses by the firm
- Significant new products, projects or services to be offered by the firm
- Extraordinary Management Changes
- Major Contracts
- Stock Splits
- Major scientific discoveries or inventions
- Significant expansion or curtailment of firm activities
- Initiation of a lawsuit or major developments in the case
- Gain or Loss of Major Contract/Supplier/Customer
- Merger with another firm

Recent Examples of Insider Trading Penalties

Sam Waksal, CEO of Imclone, received a sentence of seven years and 3 months in 2003 for breaking insider trading laws. Waksal was involved in the Martha Stewart case. He was trying to sell his stock in the company before bad news was to be released. Stewart

[2] The following material is from Manley (1990).

found out that he was selling and decided to get out as well. It is unclear whether Stewart had insider information. She was convicted for obstructing justice and covering up the reasons for her trade. She was sentenced to five months in prison and a fine of $30,000.

Under the Securities Exchange Act of 1934 persons who violate insider trading rules "are subject to civil penalties of up to three times the illegal profits gained or losses avoided by the insider trading plus criminal penalties. Criminal penalties for individuals may be a fine of as much as $5 million, prison for as long as 20 years—or both. Courts also permit injured private parties to sue for damages."[3]

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[3] "Ivancevich, Jones, and Keaveny (2002)

REFERENCES

Jones, Lucian C. and Thomas Keaveney. December 2002. “Don’t Run the Risk”, *Journal of Accountancy* http://www.aicpa.org/pubs/jofa/dec2002/ivance.htm

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http://www.owenscorning.com . (November 2005)

Table 1 Recent OCF stocks prices and returns

Date	Stock Price	Return
01/02/1992	$23.13	3.35%
01/03/1992	$22.88	-1.08%
01/06/1992	$24.00	4.92%
01/07/1992	$24.13	0.52%
01/08/1992	$24.38	1.04%
01/09/1992	$24.63	1.03%
01/10/1992	$24.00	-2.54%
01/13/1992	$23.75	-1.04%
01/14/1992	$24.00	1.05%
01/15/1992	$24.88	3.65%
01/16/1992	$26.63	7.04%
01/17/1992	$26.00	-2.35%
01/20/1992	$26.00	0.00%
01/21/1992	$25.50	-1.92%
01/22/1992	$26.00	1.96%
01/23/1992	$24.88	-4.33%
01/24/1992	$25.88	4.02%
01/27/1992	$26.63	2.90%
01/28/1992	$26.00	-2.35%
01/29/1992	$26.50	1.92%
01/30/1992	$26.25	-0.94%
01/31/1992	$26.50	0.95%
02/03/1992	$26.38	-0.47%

Table 2 Income Statement and Balance Sheet (source: Owens Corning 1991 Annual report)

CONSOLIDATED BALANCE SHEET

December 31, 1991 and 1990
(In millions of dollars)

Assets	1991	1990
Current		
Cash and cash equivalents	$ 3	$ 7
Receivables, less allowances of $ 18 in 1991 and $ 15 in 1990	308	375
Inventories (Note 6)	219	237
Deferred income taxes (Note 5)	76	79
Other current assets	13	13
Total current	619	711
Other		
Goodwill, less accumulated amortization of $ 8 in 1991 and $ 5 in 1990 (Note 17)	96	99
Investments in affiliates (Note 7)	45	32
Deferred income taxes (Note 5)	416	-
Other noncurrent assets	60	33
Total other	617	164
Plant and Equipment, at cost		
Land	51	52
Buildings and leasehold Improvements	555	545
Machinery and equipment	1,880	1,838
Construction in progress	41	60
	2,527	2,495
Less: Accumulated Depreciation	(1,657)	(1,563)
Net plant and equipment	870	932
Total Assets	$ 2,106	$ 1,807

Liabilities and Stockholders' Equity

Current	1991	1990
Accounts payable and accrued liabilities (Note 8)	$ 409	$ 418
Accrued income taxes (Note 5)	15	21
Short-term debt (Note 3)	6	167
Long-term debt - current portion (Note 2)	18	47
Total current	448	653
Long-Term Debt (Note 2)	1,148	1,086
Other		
Reserve for asbestos litigation claims (Note 1)	950	128
Other postretirement benefits liability (Note 13)	343	-
Reserve for rebuilding furnaces	113	105
Pension plan liability (Note 14)	54	44
Deferred income taxes (Note 5)	-	13
Other	126	128
Total other	1,586	418
Commitments and Contingencies (Notes 1 and 10)		
Stockholders' Equity		
Preferred stock, no par value; authorized 8,000,000 shares, none outstanding (Note 12)		
Common stock, par value $ .10 per share; authorized 100,000,000 shares; issued 1991 - 41,651,754 and 1990 - 40,580,833 shares (Note 11)	285	268
Deficit	(1,375)	(633)
Foreign currency translation adjustments	24	25
Other	(10)	(10)
Total stockholders' equity	(1,076)	(350)
Total Liabilities and Stockholders' Equity	2,106	$ 1,807

The accompanying summary of significant accounting policies and notes are integral parts of this statement.

CONSOLIDATED STATEMENT OF INCOME

For the years ended December 31, 1991, 1990 and 1989

(In millions of dollars, except share data) (Notes 17 and 18)

	1991	1990	1989
Net Sales	$ 2,783	$ 3,069	$ 2,964
Cost of Sales (Note 6)	2,186	2,304	2,161
Gross margin	597	765	803
Other Expenses			
Marketing and administrative expenses	285	309	285
Science and technology expenses (Note 4)	54	58	48
Provision for asserted asbestos litigation claims (Note 1)	24	24	50
Provision for unasserted asbestos litigation claims (Note 1)	800	-	-
Other (Notes 5 and 11)	62	16	(42)
Restructuring costs (Note 16)	-	65	30
Total other expenses	1,225	472	371
Income (Loss) from Operations	(628)	293	432
Cost of borrowed funds (Notes 2 and 3)	(131)	(165)	(166)
Income (Loss) before Provision for Income Taxes	(759)	128	266
Provision (credit) for income taxes (Note 5)	(238)	58	103
Income (Loss) before Equity in Net Income of Affiliates	(521)	70	163
Equity in net income of affiliates (Notes 7 and 17)	6	5	9
Income (Loss) before Extraordinary Item and Cumulative Effect of Accounting Change	(515)	75	172
Extraordinary loss from early retirement of debt (Note 2)	-	(2)	-
Cumulative effect of accounting change for other postretirement benefits net of income taxes of $ 117 million (Note 13)	(227)	-	-
Net Income (Loss)	$ (742)	$ 73	$ 172
Primary and Fully Diluted Net Income (Loss) Per Share			
Income (loss) before extraordinary item and cumulative effect of accounting change	$ (12.58)	$ 1.78	$ 4.08
Extraordinary loss from early retirement of debt (Note 2)		(.05)	-
Cumulative effect of accounting change for other postretirement benefits (Note 13)	(5.55)	-	-
Net Income (Loss) Per Share	$ (18.13)	$ 1.73	$ 4.08
Weighted average number of shares	40,924,391	42,019,411	42,170,273

The accompanying summary of significant accounting policies and notes are integral parts of this statement.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

For the years ended December 31, 1991, 1990 and 1989

(In millions of dollars)

	1991	1990	1989
Common Stock			
Balance beginning of year	$ 268	$ 266	$ 264
Issuance of stock and deferred awards under stock compensation plans (Note 11)	17	2	2
Balance end of year	285	268	266
Deficit			
Balance beginning of year	(633)	(706)	(878)
Net income (loss)	(742)	73	172
Balance end of year	(1,375)	(633)	(706)
Foreign Currency Translation Adjustments			
Balance beginning of year	25	14	12
Translation adjustments	(1)	11	2
Balance end of year	24	25	14
Other			
Balance beginning of year	(10)	(9)	(8)
Net increase (decrease)	-	(1)	(1)
Balance end of year	(10)	(10)	(9)
Stockholders' Equity	$ (1,076)	$ (350)	$ (435)

Table 3 Summary of Information to be released in Press Release (source 1992 Business Wire) February 6, 1992

HEADLINE: Owens-Corning takes $800 million non-cash charge to accrue for future asbestos claims

DATELINE: TOLEDO, Ohio

BODY:
"This Action Demonstrates Our Desire To Put The Asbestos Situation Behind Us," New Chairman and CEO Glen H. Hiner Says Also Takes Special Charge For Retiree Health Benefits Sets Goal of Improved Earnings In Each Quarter of 1992 -0-

Owens-Corning Fiberglas Corp. (NYSE:OCF) Thursday announced that its results for the fourth quarter and year ended December 31, 1991, include a special non-cash charge of $800 million to accrue for the estimated uninsured cost of future asbestos claims the Company may receive through the balance of the decade.

"This action demonstrates our desire to put the asbestos situation behind us," said Glen H. Hiner, Owens-Corning's new chairman and chief executive officer. "After a thorough review of the situation with outside consultants, we believe this accrual will be sufficient to cover the Company's uninsured costs for cases received until the year 2000. We will, of course, make adjustments to our reserves if that becomes appropriate, but this is our best estimate of these uninsured costs.

"With this action," Hiner continued, "everyone can now focus once again on the fundamental strengths of the Company. We generate considerable amounts of cash, our operating divisions are leaders in every market they serve throughout the world, and we have taken a number of steps in the last few years to strengthen our competitive position even further.

"As I begin my tenure as CEO," he continued, "Owens-Corning is in a very strong position for the future. We will continue to reduce costs and long-term debt, increase cash flow, enhance customer service, and actively seek opportunities for growth."

The amount of the special asbestos charge is based on the Company's estimate that its uninsured asbestos related costs will be approximately $800 million for cases received between now and the end of the decade. That estimate takes into account expert judgment on numerous variables, including anticipated case receipts, cost per case, and anticipated defense costs, and has many influencing factors, including historical levels of case receipts, demographics, and the legal climate.

Owens-Corning said it received 20,700 new asbestos personal injury claims in 1991, a decline of 7 percent from the average of the previous four years. The average settlement cost of around $9,300 per case was down slightly from the 1990 average of $9,600 per case. Owens-Corning also said that despite the accounting charge, it will litigate aggressively when plaintiffs have no impairment or exposure to asbestos.

Owens-Corning noted that the asbestos charge is a non-cash accrual that should not result in cash outlays for several years. The Company added that, given its strong cash flow, the costs of resolving claims will not affect its plans to continue to substantially reduce debt, reinvest in its businesses, and take advantage of attractive opportunities for growth. Accounting For Post-Retirement Health Benefits

Owens-Corning also said it adopted the new accounting standard in accordance with Financial Accounting Standard No. 106 for post- retirement benefits, other than pensions, effective as of January 1, 1991. The Company is taking a non-cash cumulative charge of $227 million. The Company will restate the 1991 quarterly results to reflect the effect of the change in accounting. This new standard, which is required to be adopted by all major public companies in the U.S. by 1993, requires the accrual of the cost of providing post-retirement benefits, including medical and life insurance coverage, during the active service period of the employee. Fourth Quarter and Year-End Results

Earnings for each of the Company's two operating groups were stronger in the fourth quarter of 1991 than a year ago, but the Company's performance before the special charges was significantly reduced by an increase in the estimated taxes that would be payable on undistributed earnings of foreign subsidiaries. Before the special charges for asbestos and post-retirement health benefits, Owens-Corning's income for the fourth quarter of 1991 was $3 million, or $.07 per share. This compares to income of $18 million, or $.42 per share, in the fourth quarter of 1990 before a special charge for restructuring.

After the non-recurring charge for asbestos of $12.36 per share, and a charge for post-retirement health benefits of $.16 per share, the Company's net loss in the fourth quarter of 1991 was $12.45 per share. This compares with a net loss of $.78 per share in the fourth quarter of 1990. The 1990 results include a restructuring charge of $1.20 per share for actions designed to reduce costs.

Consolidated net sales for the 1991 fourth quarter were $687 million, compared to $758 million in the same period of 1990.

Before the special charges, Owens-Corning's net income for the full year 1991 was $22 million, or $.51 per share. Including the special charges, Owens-Corning reported a net loss of $742 million, or $17.52 per share for the year, compared to a net income of $73 million, or $1.73 per share, in 1990. In addition to the restructuring charge taken in the fourth quarter, the 1990 full- year results include a charge of $2 million, or $.05 per share, for the early retirement of debt.

Consolidated net sales for 1991 were $2.8 billion, compared to $3.1 billion in 1990.

"Although economic conditions in all of our major markets were weak throughout the year, the Company's performance was reasonable, with both operating groups showing improved earnings in the fourth quarter as a result of our ongoing efforts to control costs," Mr. Hiner said. "The Company is clearly realizing the benefits of last year's restructuring, with annual savings at the predicted rate of $30 million or better.

"In the U.S., Canada and Europe, margins were impacted by pricing weakness in many of our major markets, while our Brazilian operations were hampered by the general economic malaise there.

"Despite the weak global economy, however, Owens-Corning continued to gain share in many of its key markets around the world, including residential roofing, yarns, and retail insulation," Mr. Hiner said. "I am also pleased to note that our strong cash flow enabled the Company to continue reducing debt."

During 1991, Owens-Corning's debt was reduced by $128 million to $1.17 billion, down from a high of $2.5 billion in 1986. Operations Overview

Commenting on the Company's business performance in the fourth quarter, Mr. Hiner said:

"In the Construction Products Group, sales volumes were hampered by the lack of construction activity in the U.S. and Canada. At year- end, housing starts in the U.S. were at the lowest levels in more than four decades. But lower interest rates and special tax incentives proposed by President Bush may signal an improvement in the housing sector in 1992. And our ongoing actions to control costs should bring continued benefits in the coming months.

"Margins were affected by pricing weakness in most markets in the U.S. and Canada. But thanks to our aggressive promotional activities and strong emphasis on customer service, we were able to continue to gain market share in residential roofing and retail insulation.

"The Industrial Materials Group continued to be impacted by weakness in the automotive and pleasure boat industries. In Europe, sales volumes were weak as the slowdown in the economy continued. Our Brazilian markets were affected by the general economic malaise created by the Government's restrictive monetary policies to restrain inflation.

"One particularly bright spot was in industrial yarns, with record sales in the U.S. and Europe. Demand for yarns from end-use markets and industrial weavers was particularly strong.

"Looking ahead," Hiner continued, "we expect a gradual improvement as 1992 progresses and are planning accordingly. Management's objective for 1992 is to improve earnings in every quarter as compared to the year-ago period. By continuing our focus on running our operations efficiently, controlling costs, enhancing our market leadership, and strengthening our balance sheet, I am confident we can accomplish that goal."

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TEACHING NOTE

Teaching POINTS:

Insider Trading Rules
Ethics/Societal Impact of Insider Trading
Market Efficiency
Primary Markets vs. Secondary Markets
Security Valuation
Non-cash Accounting Charges

What Happened:

When OCF published its press release the stock priceincreased 28%. Investors knew that OCF had asbestos liability but OCF had just been taking annual charges as they lost lawsuits and spent money on lawyers. This was OCF's first attempt to quantify the future liability inherent from having produced asbestos. When management presented their best guess, this was new information for the market. At the time, it was good news presumably because management had inside information and a better estimate of what the liability was than the general stock market.

In 2000 OCF filed for chapter 11 reorganization primarily as a result of the asbestos liability. In hindsight management's estimate turned out to be too low. Of course the legal environment changed from 1992 to 2000 so the 1992 estimate was the best the company could come up with at the time and the stock price increase reflected the information available at the time. One thing that is nice about the case is that it is hard for students to find information about OCF prior to 2000 when it began trading on the NASDAQ bulletin board so they have to think about the situation rather than find out what actually happened.

Questions for Class Discussion:

1. **Disregarding Legal and Ethical Issues what should David do if he wants to take advantage of this information?**

Students typically jump on this question and say sell or short the stock. The day of the asbestos write-off announcement OCF increased about 28%. This usually surprise them and I ask for them to give reasons. This is a good time to discuss market efficiency. The market knew that OCF had asbestos liability. By assigning a value to the liability, management provided additional information to the market. In this case we can infer that the market expected the liability to be even worse than management thought. When management assigned a number to the liability, the market inferred that the liability wasn't as bad as originally anticipated causing the price to increase.

2. What is a write-off?

I usually don't assign this as a question. I ask the students after they answer question #1. I emphasize the point to the students that write-offs are bookkeeping entries and typically they do not involve cash. We can expect that the market will already be assessing the economic impact of events such as lawsuits that will affect the firm and try to determine the cash flow impacts both now and in the future. In Owens Corning's case the market was already assessing the future cash flows. However, management's estimate gave the market more information to go on.

3. What legal implications would David face if he acts on this information?

If convicted David could face jail time, payment of any profits and punitive damages. Stock exchanges have computer algorithms that look for unusual trading around certain dates. These algorithms look for unusual trading in the same zip code, family names that are similar to company employees, etc. Although not very many insider trading cases are brought by the SEC every year, if a case is brought the SEC tries to make examples to use as deterrents for others that might think about illegally trading on inside information. In 2000 the SEC charged Jonathan Lebed, a 15 year old, with manipulating stocks in a high profile case. Some would argue that Lebed was targeted because of his age and the attention the case would draw in the media.

4. What is the difference between the primary market and the secondary market? Which market would David trade the Owens-Corning stock in?

The primary market is when firms' first issue their shares to the public. The secondary market is where these shares are bought and sold by individuals who hold the shares. David would make his trade in the secondary market.

5. What are the societal impacts of insider trading? Does anyone get hurt if David takes advantage of information he should not use?

If some market participants have an unfair advantage they will be able to earn abnormal returns. If these individuals are able to make abnormal returns it comes at the expense of people who do not have information. The uninformed people are not stupid. If they continuously lose money investing in the stock market they will stop investing in this market. If secondary markets do not have good liquidity and people willing to buy and sell shares, firms will have difficulty raising money on the primary market. This lack of access to capital will hurt entrepreneurial and small firms and make it difficult to grow. Taken to an extreme insider trading will depress the economy and job creation. While insider trading may have faceless victims it is a real threat to our society.