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Can VEBAs alleviate retiree health care problems?

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Can VEBAs alleviate retiree health care problems?

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Abstract

The 2007 negotiations between the United Auto Workers (UAW) and Detroit automakers have focused national attention on a potentially innovative response to the long-term decline in retiree health insurance in the United States. The union agreed that an independent trust called a Voluntary Employees' Beneficiary Association (VEBA) will assume responsibility for UAW retiree medical care at the three automakers. Other unionized employers now are looking at these so-called defeasance VEBAs as a way to free themselves of burdensome health-care legacy costs. An analysis of the largest one, at GM, suggests that the concept is a second-best option for unions able to retain employer-paid retiree coverage. However, it may be a viable alternative for those unable to fend off unilateral elimination by an employer. Both private- and public-sector unions and employers can draw important lessons from the defeasance VEBA agreed to by the UAW and GM, which will deploy innovative tactics to distribute cost and risk amongst the company, workers, and retirees. More broadly, the new VEBAs illuminate a gaping hole in the federal tax code, which offers few incentives for employees to save for post-employment medical needs even as employers have shifted the responsibility on them to do so. A VEBA is a flexible vehicle that could provide the most tax-efficient savings method for workers whose employer doesn't offer retiree coverage. However, changes in federal law likely would be required for the concept to become widespread.

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Introduction

The 2007 labor negotiations between the United Auto Workers (UAW) and Detroit automakers have focused national attention on a potentially innovative response to the costly problem of retiree health insurance that cuts across the public and private sectors To alleviate the companies' chronic losses, the union agreed to the establishment of Voluntary Employees' Beneficiary Associations (VEBAs) at General Motors Corporation, Ford Motor Corporation, and Chrysler Corporation. These nonprofit trusts, which will be run by an independent board of trustees, will assume responsibility for UAW retirees' medical care, allowing the three companies to remove a total of more than $100 billion in long-term liability from their books.[1] When the trusts are up and running in 2010, the UAW and its retired members will shoulder the risk of ensuring that the funds are sufficient to cover the cost of future medical inflation.

VEBAs are tax-free trusts employers can set up to fund retiree health and almost any other employee benefit. While VEBAs have existed for close to 100 years, companies only recently have used the idea to transfer responsibility to workers. The new-found prominence of this strategy comes in the context of a mounting societal problem posed by a years-long decline in employer-paid health coverage for former employees and their families. For several years, some experts have suggested that stand-alone employee VEBAs like those being set up by Detroit might help fill in the gap, either by taking over the burden from employers like the auto companies that are unwilling to bear it any longer, or by extending tax breaks to employees who don't have employer-paid retiree coverage in the first place. However, the latter idea likely would require changes in federal tax law, since employee VEBAs typically don't provide a full array of tax benefits to non-union workers.

Still, the new visibility of the concept spotlights a broad hole in the federal tax code, which offers few incentives for workers to save for their post-employment medical needs — even as employers increasingly place the responsibility on them to do so. As rising medical inflation swells the cost of retiree health care, workers increasingly face the issue of how they can pay for it and whether they should try to put aside funds for this purpose along with other post-employment savings. If they do, the tax code offers only a few options, such as Health Savings Accounts, 401(h) accounts, and S. 115 trusts for public employees. But none offer the full array of tax breaks found with a VEBA.[2]

A Detroit-style employee VEBA poses a complex challenge for labor in both the private and public sectors. Union members in VEBAs funded at least partially by employers enjoy tax breaks denied to nonunion employees. As a result, such trusts can be a tax-efficient way for organized workers to save for post-employment health coverage. However, for unionized employees covered by an employer-paid plan, it may be a second-best option to go along with a GM-style defeasance VEBA, so-called because it allows employers to sever their debt obligations for health care legacy costs. The new labor pacts in Detroit may raise the stakes for many unions, because they have spurred interest amongst other unionized employers that also have long desired an escape from legacy costs imposed by retiree health.[3] Many cities, states, and other public-sector employers also are struggling with large legacy costs they want to curtail or shed altogether. Some may be attracted to employee VEBAs, possibly even defeasance ones, or similar methods of pre-funding retiree health costs.

Because VEBAs are a flexible concept that can be adapted to a variety of situations, employers and unions battling over legacy costs can draw important lessons from those being set up in by the UAW and USW. The first section of this paper describes the general history of VEBAs and why they have surfaced as an issue at unionized companies. The second section examines the advent of stand-alone employee VEBA like those under construction in the auto industry. The third focuses on the bargaining trade-offs made by GM and the UAW as they negotiated the new employee VEBA, which involved a variety of innovative financing maneuvers that are likely to stand as a template for other employers and unions engaged in similar struggles. The concluding section looks at VEBAs in the larger context of declining retiree health coverage in the United States and discusses possible ways in which the idea could address the issue for both union and nonunion employees. It also examines how employee VEBAs may apply in the public sector, where many employers face legacy costs as burdensome as those in autos and steel.

Section One: Why VEBAs have come to the fore

A VEBA is a tax-exempt trust as defined under Section 501(c)(9) of the Internal Revenue Code. Their purpose is to give employers and/or employees a tax-advantaged method for funding not just medical care, but virtually any qualified employee benefit, such as dental care, prescription drugs, life and accident insurance, or vision care. VEBAs even can be used to pay for things like vacations, child care, training, education, legal expenses, or supplemental unemployment benefits.[4] They can do so not just for employees, but also for their spouses and dependents.

Federal law sets low limits on how much money employers and employees can put into a VEBA for nonunion workers, which limits their usefulness for most of the U.S. workforce. However, for those who qualify, they offer one of the best tax breaks around. If set up properly, contributions by employers and employees alike aren't taxed going in, any earnings the trust makes over the years aren't taxed, and the money withdrawn to cover a retiree's medical care isn't taxed, either.[5] This is much better than a retirement plan such as a pension or 401(k), whose distributions in retirement are fully taxable.

VEBAs also are remarkably flexible. They can be set up as individual accounts akin to a 401(k), in which contributions are made by the employer, the employee, or both. Or they can be a "commingled trust," which functions more like a traditional defined-benefit pension and pays a fixed dollar amount to cover qualified benefits. Companies also can use a hybrid approach, in which the trust is funded by a defined contribution such as a lump sum, yet pays the premiums of a traditional health plan.[6] Employers can decide whether to fund a VEBA themselves or require employees to pay part or all of the contribution. Some VEBAs in the public sector even use sick days or other compensable time off as a funding source. The employer contributes the value of the time off, either annually or on a one-time basis when the employee retires.[7]

Most of the 12,200 VEBAs in existence today are set up by employers as a tax-advantaged funding scheme.[8] The board selects professional investment managers and investment vehicles and decides on distribution options and levels.[9] The new VEBAs at Goodyear and the auto companies will be run independently of the company. Although called stand-alone or employee VEBAs to emphasize the point that employees bear all the risk that the employer has severed, these trusts are legal entities separate from both the employer and the union.

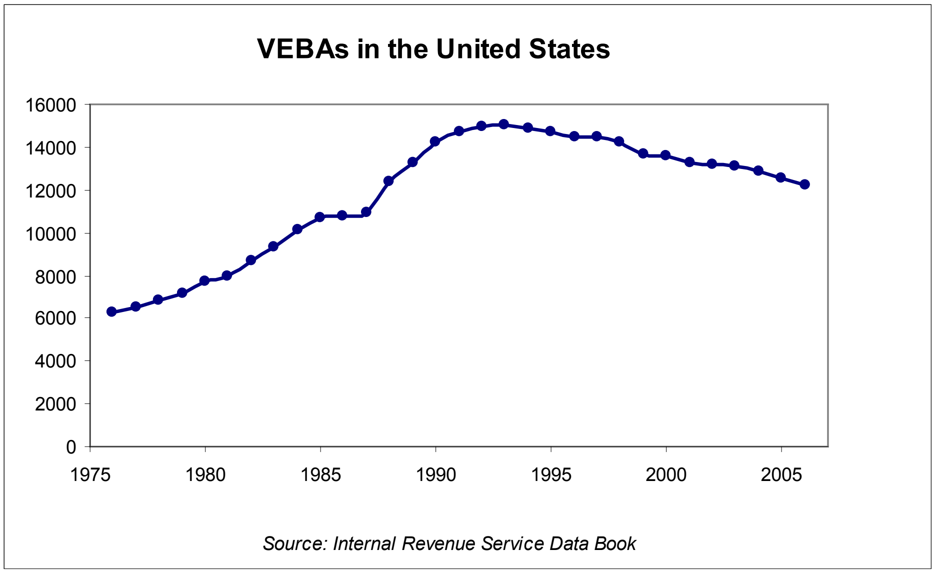
VEBAs first appeared in the early 20th Century as a way for workers to fund insurance for life, health, and accident, as well as other benefits that employers typically did not cover at the time. After several courts decided that they should be taxed, Congress granted them tax-exempt status in 1928.[10] The tax rules changed several times in subsequent decades, most drastically in 1984. That year, Congress imposed low limits on how much employers could contribute to a VEBA and required companies to pay unrelated business income tax on any annual gains earned on funds exceeding the limits. The purpose was to crack down on companies abusing VEBAs as tax shelters.[11]

However, VEBAs at unionized employers remained exempt from the restrictions, so workers there can make tax-free contributions to a VEBA as well as receive benefits from it tax free.[12] As a result, they have remained popular at companies with large unionized workforces in both the public and private sectors. The trusts have been especially prevalent in industries such as utilities, where the annual employer contributions can be built into the rate base, and in defense, where companies can build them into cost-plus federal contracts.[13] Typically, employers use them to pre-fund their long-term retiree health obligations. VEBAs also are used for this purpose by multi-employer health and welfare plans, which usually involve a union that has set up a plan covering members at multiple companies.

VEBAs remained attractive to companies for another reason as well. Just like a corporate pension fund, any extra returns a company-sponsored plan earns are included in a company's bottom line (assuming the plan is a traditional one and not the newer stand-alone variety like those in the auto industry). For example, Procter & Gamble Company's VEBA added more than $600 million to the company's earnings since 2005.[14] Indeed, despite the 1984 limitations, the number of VEBAs in the United States more than doubled in the 1970s and 1980s, reaching a peak of 15,048 in 1993.

While few employer surveys shed light on the reasons for this growth, it likely stemmed in part from companies' desire to salt away funds to defray the mounting costs of an aging workforce, especially in mature unionized industries. Retirees also were living longer,

Table 1. VEBAs in the US 1976-2006



Year	VEBAs
1976	6271
1977	6486
1978	6827
1979	7122
1980	7738
1981	7995
1982	8703
1983	9303
1984	10145
1985	10668
1986	10776
1987	10927
1988	12360
1989	13228
1990	14210
1991	14708
1992	14986
1993	15048
1994	14835
1995	14681
1996	14486
1997	14464
1998	14240
1999	13686
2000	13595
2001	13292
2002	13173
2003	13066
2004	12866
2005	12567
2006	12206

further ratcheting up a long-term obligation that employers could use VEBAs to fund.

It was this swelling long-term liability that eventually led employers to the idea of using VEBAs to transfer retiree health responsibility to union members. The root of the notion stems back to a 1990 regulatory action that for the first time required employers to record retiree health obligations as a debt. Until then, most employers simply paid the annual cost of retiree health premiums out of their general budgets, an approach often called pay-as-you-go accounting. But that year, the Financial Accounting Standards Board, which provides guidelines for the financial reports of public corporations, issued Financial Accounting Statement No. 106.[15] Starting in late 1992, FAS 106 required companies to use what's called an actuarial accounting method, which requires them to record a liability on their books for the total cost of their unfunded retiree medical obligation. Put another way, companies had to state the present value of what they would need to pay in the future for all retiree health coverage, both for retirees and for active workers.

The move had a profound impact on employer-paid retiree health. Even before FAS 106 focused attention on the issue, concerns over swelling legacy costs had begun to degrade the credit ratings and stock values of employers with large ratios of retirees to active workers. As a result, many corporations had decided that the expense was simply too large and had begun abolishing retiree health insurance. Much of the retrenchment came amongst large employers, which had always been more likely to offer retiree coverage than smaller ones.[16]

FAS 106 heightened the concern by requiring employers to post a liability on their balance sheet that for many large corporations ran into the millions or even billions. Some companies responded by taking the hit all at once, with a one-time charge against their earnings. Other chose to stretch out the cost over many years.[17] A few even were forced into bankruptcy.[18] Some experts believe this helped to accelerate the decline in retiree coverage: Employer-paid insurance for early retirees, who need it the most before Medicare kicks in, was offered by 46% of companies with 500 or more employees in 1993 but only 28% in 2004.[19] Since then, the number of VEBAs has drifted downward as well, to 12,206 in 2006.[20]

Some of the companies that chose to keep paying decided to use VEBAs to pre-fund the obligation, as did some public-sector employers.[21] GM itself set up such an internal VEBA years ago, long before it asked the UAW to take over responsibility for retiree coverage. By the time 2007 bargaining began, GM had salted away $16 billion into this pre-existing VEBA.[22]

Section Two: Stand-alone Employee VEBAs

The new employee VEBAs used by the three auto companies to shed legacy costs have a different form from a traditional VEBA. They are defined-contribution trusts in which the company puts a specified set of assets that will be used to cover all benefits in the future. Unlike a traditional pension or a defined-benefit VEBA, a stand-alone VEBA involves no guarantee by the employer of a certain level of benefits, leaving employees to bear the risk that the assets won't keep pace with future medical inflation.

The tax lawyer's phrase for what the auto companies are doing is defeasance, which means setting aside assets to void a debt obligation. Management-side labor lawyers dislike the term, since many companies have asserted that retiree health isn't a legal obligation at all. From management's perspective, the cost being shifted is one many companies voluntarily took upon themselves, a decision they're free to reverse at any time.

Indeed, employers' legal right to stop paying for retiree health has long been a point of contention between labor and management. Companies face fewer legal hurdles for doing so than they do with pensions, since welfare benefits such as retiree health don't vest under the Employee Retirement Income Security Act of 1974 (ERISA). As a result, the question of whether a company has incurred a legal obligation by offering retiree health coverage over the years turns on the specific facts of what it told employees.[23] The issue has been litigated at many companies, with labor prevailing in some instances and management in others. The outcome usually depends on whether statements and other actions by the employer can be construed as an explicit or implied promise to continue health coverage throughout employees' retirement.[24]

While this legal uncertainty can make it difficult for employers to shed retiree health coverage for unionized workers, it's much easier when a company enters bankruptcy. Seeking court protection from debtors allows companies to reduce or eliminate almost all debts, which can obviate the issue of whether retiree health is a legal obligation or not. After dozens of steelmakers failed starting in the late 1990s, more than 200,000 United Steelworker retirees and their dependents lost coverage as their companies either restructured their debts or simply went out of business.[25]

As a result, most defeasance VEBAs have come at companies that have either entered bankruptcy or faced real prospects of doing so.[26] The UAW was involved in one of the earliest examples of this, which was a VEBA set up in 1992 during the bankruptcy of International Harvester Company (now called Navistar International Corporation). The company put $500 million into the trust, enough to cover about half of the projected liabilities, and promised to pay more in subsequent years. The trust continues to cover retirees, whose benefits have increased, although co-pays have risen somewhat.[27] Other experiences haven't gone as well, such as a VEBA the UAW agreed to at Detroit Diesel Corporation which ran out of cash.[28]

One of the most innovative uses of a VEBA involved the USW's efforts to salvage medical coverage lost following bankruptcies in the steel industry. The effort, which started with the former LTV Corporation and eventually came to involve three other bankrupt steel companies, illustrates how VEBAs like those in the auto industry typically are part of a larger set of bargaining trade-offs unions and employers make to balance the interests of the employer and active and retired workers.

In 2001, LTV went into bankruptcy and began selling its assets.[29] Most of its workforce was laid off and retirees lost their health insurance. To save what it could, the USW began negotiating with investor Wilbur L. Ross, who wanted to buy some of the company's nearly shuttered steel mills. In exchange for supporting his purchase the following year, the union agreed to weaker work rules that allowed Ross's newly formed International Steel Group Incorporated (ISG) to reopen the mills with fewer workers, higher productivity, and lower labor costs. The union also agreed that ISG could buy LTV's physical assets, leaving the $2.3 billion in retiree pension and health obligations that had been a factor in the former company's demise to a shell company with insufficient assets to cover them. The agreement left 70,000 retirees and dependents with no recourse except to apply to the federal Pension Benefit Guaranty Corporation, which guarantees a portion of employee pension payments in case of bankruptcies. However, they had no similar recourse for health coverage, which isn't protected by the PBGC.

In return, Ross agreed to rehire laid-off LTV workers as the company recovered and to negotiate a new labor pact with the USW. The deal eventually came to cover Bethlehem Steel Corporation, Acme Metals Incorporated, and Georgetown Steel. (Ross sold ISG and the company today is called ArcelorMittal USA.)[30]

Although the union's priority was to save as many jobs as possible, it also negotiated an unusual VEBA with Ross that today provides limited health coverage for the four companies' retirees. Because ISG, as it was known then, had no profits and an uncertain future when the USW reached the agreement in 2002, the two sides decided the company couldn't afford to make any hard commitments to retiree health. Instead, it set up a VEBA that's funded by a percentage of operating cash flow per ton of steel shipped.[31]

The arrangement paid nothing until 2005, when the trust had accumulated enough money to start modest benefit coverage. Initially, retirees got prescription drug coverage for a $10 monthly co-pay.[32] The following year, as the company continued to earn profits, the VEBA's assets swelled to $469 million, enough to allow it to pick up the tab for part of retirees' Medicare Part B premium.[33] The trust earned enough to repeat the benefit in 2007.[34]

While such benefits are much better than nothing, they're a far cry from full coverage. Nor has the trust been able to build up a fund like those being established in Detroit and at Goodyear, which will be able to guarantee at least some level of benefits for many years. Instead, coverage for ArcelorMittal retirees will fluctuate with the company's fortunes.[35]

Section Three: How GM and the UAW split cost and risk

While the USW's experience at ArcelorMittal exemplifies how the innovative use of a VEBA can aid retirees who've lost all coverage, GM's defeasance VEBA offers more lessons likely to be of use to a broad cross-section of unions and employers. The primary obstacle faced by employers who hope to shed a retiree health burden—in addition to prevailing upon their unions to agree—is to find enough assets to fund the trust at a level that's likely to cover future medical inflation. For unions, the key issue is ensuring that it will be funded as fully as possible. GM and the UAW devised a package of creative financing options that allowed them to reach a middle ground on this central question.

In doing so, they forged compromises on a range of sensitive issues that others would face in a similar process, including how much of the funding expense will be borne by the company, by active workers, and by retirees. An examination of how these compromises allowed the parties to structure and fund the new VEBA offers insights applicable to other industries. Not every union or employer will want or be able to emulate every tactic, but most that pursue a defeasance VEBA are likely to adopt at least one or more of them.

The GM VEBA came about in very different circumstances from those at ArcelorMittal. It represents the culmination of a years-long struggle by GM to shed its legacy costs. Successive CEOs at the company had argued that ballooning UAW pension and health-care payments had crippled the company's ability to compete. In many ways, this argument confuses cause and effect. After all, the company's market share slid from 40% of the U.S. market 20 years ago to just 25.5% in 2007 largely because of its inability to design vehicles that were more appealing than those offered by Japanese rivals.[36] The market share loss prompted the company to shed hundreds of thousands of workers, which in turn lifted the ratio of retirees to active workers to unsustainable levels.

Still, whatever the cause, GM, Ford, and Chrysler all undeniably have borne the burden of the enormous sums they expend on legacy costs. GM frequently points out that it is the single largest purchaser of health care in the United States, providing coverage to 1,100,000 active and retired workers and their dependents. Of the $5.4 billion GM spent on health care in 2005, more than two-thirds paid for retirees, adding $1,045 to the average cost of a GM vehicle. By contrast, its Japanese rivals paid just $450 per vehicle on all health care benefits, for active workers and retirees alike.[37]

GM first prevailed on the UAW to reduce retiree health costs in 2005. In an unusual mid-contract concession, the union agreed to changes — including higher co-pays and deductibles — that sliced $17 billion off the company's $67.6 billion retiree health care obligation.[38] As part of that deal, it agreed to give up $5.6 billion worth of negotiated future wage hikes and cost of living adjustments (COLAs). In return, the company offset a portion of the cutbacks by setting up a defined-contribution VEBA funded with three $1 billion payments through 2011, plus at least $30 million a year in profit-sharing payments and additional payments based on increases in GM's stock price.[39] This trust was called a mitigation VEBA, because it severed only a portion of the company's retiree health obligation, not all of it as the 2007 defeasance VEBA is designed to do. During these negotiations, GM retained responsibility for UAW retiree health coverage, which it will not once the 2007 stand-alone VEBA takes over.

An analysis of why the UAW agreed to this extraordinary move sheds light on its acceptance of the 2007 VEBA. The threats that prompted the UAW to make both concessions were largely the same. In 2005, GM was struggling with deepening financial and competitive woes. Its stock had fallen by more than half, from $53 in 2003 to $19 at the beginning of 2005, and its credit rating had been slashed to junk status.[40] To address the problem, management closed or idled factories, laid off 37,000 employees, and cut executive salaries and the dividend to shareholders. It also demanded that the UAW agree to steep reductions in retiree health. When the union refused, GM threatened to impose them unilaterally. That left the union with a difficult decision. It could agree to bargain over the mid-contract cuts in the hope of minimizing them. Or it could refuse outright and sue if GM cut them on its own. The downside to the latter strategy was that if GM prevailed in court, management could emerge with the unilateral right to eliminate retiree health benefits altogether.

The second threat the UAW faced was that a victory in court could turn out to be a Pyrrhic one. In light of Wall Street's negative view of GM's future, bankruptcy was a distinct possibility should the UAW prevail in a legal battle over legacy costs. If that happened, as the 6th Circuit Court of Appeals pithily pointed out in a ruling on the legality of the 2005 cuts: "…it is well to remember that the Federal Government's Pension Benefit Guaranty Corporation, which provides *pension* guarantees for the employees and retirees of financially distressed companies, has no sister agency that provides the same guarantees for retiree *healthcare* benefits."[41] In other words, if GM declared bankruptcy, retirees could lose more than the $17 billion cutbacks the company demanded in 2005, perhaps even all their health coverage. In light of these twin threats, the UAW decided that saving some benefits was better than the risk involved in giving no ground at all.

The UAW made largely the same calculation during the 2007 contract talks. However, this time the two sides were discussing a full-scale defeasance VEBA that would take the entire remaining retiree health obligation off GM's books. The UAW insisted that in exchange for workers assuming the responsibility for future coverage, the company had to fully fund the trust. The arrangement the two sides eventually agreed on was based on an intricate series of compromises. It allocated some of the funding cost to the company and some to active workers (retirees were spared any further immediate cuts on top of the ones they suffered after the 2005 concessions). It also split the risks the VEBA will entail for retirees between GM and union members. Overall, the agreement allowed the UAW to assure its members that they had wrested enough funding out of GM to ensure full coverage for retirees (although only for what remained after the $17 billion reduction in 2005). Yet it did so in a fashion that GM believed it will be able to afford, even in its distressed circumstances.

The middle ground the parties reached came on two levels: The amount of the funding to be split between GM and union members, and the key financial assumptions to be employed in the funding calculations. The latter entailed an assessment of the costs the VEBA would incur, as well as the returns its assets could be expected to realize to pay for future retiree coverage. To arrive at a cost figure, the two sides had to decide what rate of medical inflation to use. Since standard actuarial projections for retiree health obligations range over 80 years, even a percentage point can have a huge effect on the size of the total cost. Eventually, the two sides settled on 5% as a long-term average for U.S. health-care cost increases.[42]

At first blush, this seems wildly optimistic given the double-digit increases of recent years. However, many experts use something in that ballpark for long-term projections, on the assumption that the current pace is simply unsustainable over decades.[43] Still, by agreeing to what today seems like a relatively low assumption, the UAW made the sum to be funded more affordable to GM. In doing so, it also may have heightened the risk that the VEBA will face shortfalls, especially in the short to medium term, for which retirees and the union will be responsible.

The 5% assumption resulted in a present-value estimate of GM's long-term retiree health obligation that totaled roughly $47 billion.[44] This figure represented the cost of covering all current retirees and their dependents, as well as all currently active UAW members at GM and their dependents. It excluded any new hires GM might make in the future, who will not be part of the new VEBA. (Union members hired after September, 2007 will receive $1 per compensated hour that will go toward covering their retiree health care costs, a significant reduction in benefits compared to existing UAW members.)[45]

The UAW also agreed to a relatively generous figure for the second critical financial assumption, about projected returns. Just as the 5% medical inflation assumption made the long-term cost more manageable for GM, a high assumed rate of return allowed the two sides to put up less money to meet that cost. Ultimately, the two sides settled on 9%, even though GM will use a much more pessimistic 6% on its own books.[46] The higher figure meant that GM only needed to come up with about $38 billion, instead of $47 billion, for the VEBA to be considered fully funded.[47]

This 9% rate of return was probably a reasonable assumption for both sides.

While GM's own accounting assumption of 6% suggests that it may be optimistic, the rate is actually a bit less than the 10% long-term average that stocks have returned over the decades. Since the VEBA trust is designed to last for many decades, it made sense to use a rate matching that time horizon. However, it does mean that the trust may lack a large cushion to buffer the inevitable fluctuations in returns that most investors experience. If returns slump for years in a row, trust officials may be forced to reduce benefits at least temporarily, until the market reverted to the mean and returns recovered.

The two sides reached another series of intricate compromises on the divisive issue of how much each of them would contribute toward the $38 billion in required funding. In some sense, union members paid for the entire sum, since the contributions GM will make were given in exchange for job, wage, and work-rule concessions. Still, GM will put up slightly more than $30 billion of the total directly, while UAW workers will pay for the remaining $8 billion by diverting future pay hikes into the VEBA. Here's how much each party contributed.

Table 2. GM VEBA Funding

	Amount	Source
From GM		
	$16.0 billion	Transfer from existing VEBA
	$5.4 billion	Cost of paying retiree health until VEBA starts in 2010
	$4.37 billion	Convertible note
	$1.74 billion	Backstop payments
	$1.7 billion	Excess pension funds
	$1.0 billion	2005 payment due in 2011
Total	$30.21 billion	
From the UAW		
	$5.6 billion	Diverted 2005 wage hikes and cost of living adjustments
	$2.5 billion	Diverted 2007 wage hikes and cost of living adjustments
Total	$8.1 billion	
Total	$38.31 billion	

Source: GM 2007 GM-UAW Labor Agreement Conference Call, October 15, 2007, and accompanying slide show, available at http://media.corporate-ir.net/media_files/irol/84/84530/2007_GM_UAW_Labor_Agreement_Call.pdf; and GM's 8-K filed with the Securities & Exchange Commission on October 15, 2007, at: http://www.gm.com/corporate/investor_information/sec/.

GM's contribution came from a variety of sources:

Transfer from existing VEBA

GM's financial cost was made easier by the $16 billion already saved in the internal VEBA it had set up years ago. The money served as a convenient base on which to build the new defeasance VEBA.

Cost of paying retiree health until 2010

Much of the rest of GM's contribution came from financial moves that also won't require new cash outlays by the financially strapped company. The two sides agreed to count as part of the VEBA funding the $5.4 billion GM will pay to continue the current defined-benefit retiree health plan through the end of 2009, until the new VEBA is up and running (the start date was set for January 1, 2010.)

Convertible note

The UAW accepted another $4.3725 billion in the form of a note convertible to GM stock. When the note is issued in January, 2008, it will require GM to make semi-annual interest payments to the trust. Six months before the note matures in five years, the trust will have the right to convert it into about 109 million shares of GM stock, based on a $40 conversion price. It can do so before if GM shares exceed $48.

While the note isn't a straight stock grant, it's not as solid as cash and thus introduces more uncertainty into the VEBA's long-term financial outlook. For example, if GM declared bankruptcy, the note would rank as unsecured and unsubordinated debt. As a result, it would stand a lower chance of full recovery relative to more senior debt and might well be all but wiped out, a common occurrence with such debt in bankruptcy.

Similarly, if the trust converts the note into GM shares, their value would fluctuate with the market price. In a bankruptcy, their worth would very likely fall close to zero. In addition, the agreement puts strict limits on the VEBA's ability to convert the note. For example, it can't be sold or even hedged until 2010 without GM's consent. After that date, the trust only can sell about half of the note or converted stock per year. And it can't sell more than 2% of it to one owner. Another significant restriction requires the trust to vote the stock in the same proportion as all other GM shareholders, which effectively deprives the VEBA—

and hence the union, which appoints the trustees — of the ownership power to exercise corporate governance rights over GM.

Of course, the note offers the VEBA a potential upside, just as any stock ownership does. The trust stands to gain more than $1 billion for every $10 increase in GM shares over the $40 conversion price. In addition, such a large ownership stake — 109 million shares will represent about 16% of GM's outstanding stock — will link the UAW to GM in a new way. A Citigroup Global Markets Incorporated report said: "We view the UAW's willingness to accept a $4.4 billion convertible note… as a positive seeing that both sides' interests should be better aligned going forward. The UAW's desire to hold an equity-linked security in the VEBA may also suggest that the union sees future upside potential in GM shares."[48]

Backstop payments

To allay UAW concerns that the trust might not earn enough to cover future costs, GM agreed to make $1.74 billion in 20 annual contingency payments, with the first $165 million guaranteed to be paid in April 2008. These constitute a backstop to take effect if the VEBA's returns fall below projections. GM is committed to making a payment in any year in which the trust's cash flow projection shows that it lacks enough money to cover all benefit costs over the ensuing 25 years. However, it's likely that the company will be required to make most or all of the payments, since they were included in the union's analysis that $38 billion will fully fund current retiree health benefits over the long term.[49]

Excess pension funds

Another $1.7 billion came from what appears to be an innovative maneuver to tap excess cash in GM's pension plan. In 2003, the company injected $13.5 billion into the plan from a bond offering and another $5 billion from selling its stake in Hughes Electronics.[50] By 2007, the pension was over-funded by $17 billion.[51] However, under federal pension rules the over-funding wasn't sufficient to allow GM to withdraw money to use for the VEBA. Instead, the union agreed to require retirees to contribute $51.67 a month to the VEBA, and offset the cost by a grant GM will make of a special monthly pension increase of $66.70.[52] The pension pass-through, as it's called, will generate $1.7 billion for the VEBA (in present-value terms) at no cost to retirees.

2005 payment due in 2011

The last part of the funding came from the final $1 billion payment due in 2011 that GM had promised during the 2005 mid-contract cutbacks, which will now be counted toward the new VEBA.

The UAW's contribution came from member concessions:

2005 wage and COLA diversions

Union members' largest sacrifice for the VEBA came from the $5.6 billion in wage hikes and COLAs it had agreed in 2005 to divert to retiree health care, to offset the $17 billion in cuts made that year. The UAW also granted GM the option of spreading out the payments over 13 years.[53]

2007 wage and COLA diversions

During negotiations over the new VEBA this summer, the UAW agreed to redirect additional wage and COLA increases it had negotiated, which added another $2.5 billion.

Although the complex series of compromises the UAW and GM made should allow the company to sever its retiree health care liability, GM still may find itself bargaining over the issue down the road. The agreement the two sides reached states that "The UAW and the Covered Group may not negotiate to increase any of the funding obligations set out herein. The UAW also agrees not to seek to obligate GM to: (i) provide any additional contributions to the New VEBA; (ii) make any other payments for the purpose of providing Retiree Medical Benefits to the Covered Group; or (iii) provide Retiree Medical Benefits through any other means to the covered Group." Presumably, such explicit language will convince the Securities & Exchange Commission that GM no longer is responsible for UAW retiree medical coverage and therefore can wipe the billions in FAS 106 debt off its books.

However, directly following the above language is a second sentence which says: "Provided, that, to the extent that may be proposed by the UAW, employees are permitted to make contributions to the New VEBA of amounts otherwise payable in profit sharing, COLA, wages and/or signing bonuses." This second clause left open the door to new bargaining over retiree health in the future. If the current contract helps GM to prosper again, as it's designed to do, there's nothing to stop the UAW from demanding pay or profit-sharing increases large enough to satisfy active workers and still leave some left over for the VEBA.

In fact, from the perspective of GM's legal position, its entire battle for the defeasance VEBA would seem to change nothing. The company maintained in court that it never had a legal obligation to pay for retiree health care and could terminate it at any time. In this view, the only reason management kept spending billions every year was to avoid a strike by the union. That's exactly the position GM will be in once the new VEBA is set up: The union will be free to threaten work actions to extract promised payments for retiree care that could easily mount into the billions again.

Of course, the company's legal theory was never tested by the courts, and it's entirely possible that the union would have prevailed in its view that retiree health was indeed a legal debt GM was obligated to cover. Even so, there would appear to be little to prevent the UAW from demanding more payments from a healthy GM in the future.

VEBAs like the one being set up at GM present a mixed set of problems for unions. They do offer several advantages over employer-provided insurance. The most significant: They put workers in the driver's seat. The GM one will be a stand-alone entity controlled by a board of five UAW-appointed trustees and six public ones whose sole responsibility will be to the beneficiaries.[54] The trustees can choose a mix of benefits that best suit workers' needs, without input from employers. Such stand-alone VEBAs also can help protect both active and retired union members from cutbacks by employers. In addition, such trusts offer a fair degree of insulation from employer bankruptcy, depending on how well funded the trust is and whether it has employer stock.

However, the disadvantages could very well outweigh these gains. The flip side of the control an employee VEBA conveys to workers is the risk it brings with it. When employers pay for retiree health, they bear the cost of future medical inflation. With a stand-alone VEBA, workers and retirees do. If trust assets don't earn enough to keep pace, unions will need to make the painful decisions about how to cope. Employees also must deal with any financial deficiencies or even failures caused by mismanagement of an employee VEBA.

Employee VEBAs lead to an even greater level of risk if they are set up from the beginning with insufficient funds. If a union has the clout to convince employers to set up fully-funded VEBAs, the independence they offer conceivably might be worth the extra risk. However, even prosperous unionized companies may seek VEBAs that sever their retiree health obligations at a discount.

Nonetheless, even less than fully funded defeasance VEBAs may be better than the alternative. Both GM and Goodyear threatened to reduce retiree health coverage or eliminate it altogether if they did not agree to sever the company's retiree health liability. Given the uncertainties that would be involved in litigation over such actions, unions facing them run a very real risk of losing all retiree coverage. Even a partially funded VEBA may be a safer bet.

The auto companies and Goodyear exemplify another reason why defeasance VEBAs may be a good alternative for some unions. All are financially troubled companies that have faced periodic brushes with bankruptcy. Since such an outcome also could severely reduce or eliminate retiree health coverage, labor's acceptance of employee VEBAs increased the likelihood that retirees would hold onto at least some of their insurance.

One way in which stand-alone VEBAs could turn out to be a real windfall is if some form of national health care reform is passed in the United States. If a new system provided workers with access to affordable care, UAW members and others with extra funds saved in a VEBA could be much better off. The funds the auto makers contribute can't be removed after they're put in, which means union participants would be able to use them to supplement any new national health system. They also would come out ahead if reforms moderated medical inflation, which would improve the odds that VEBAs wouldn't run out of money.

Section Four: VEBAs as a remedy for declining retiree coverage

Even before GM and the UAW agreed to the new VEBA, some experts had suggested that the concept could help a broad swath of employers and employees to manage the mounting cost of retiree health insurance.[55] The most immediate application likely would be to unionized employers and workers in both the public and private sectors.

It's possible that more heavily unionized public-sector employers may attempt to use VEBAs to shake off burdensome legacy costs, as some analysts began urging them to do after GM succeeded.[56] However, given the different political dynamics of government employment, defeasance could be even more difficult for them to achieve than it has been for corporations.

The legacy-cost pressure bearing down on public employers is strikingly similar to those that have played out in the private sector. Although many public employers only have focused on the issue in the past few years, their burden may be just as onerous. Indeed, some estimates peg the total unfunded public-sector liability for retiree health at close to $1 trillion.[57] The subject has gained new urgency due to the same kind of mandate to report these unfunded obligations that FAS 106 placed on private companies. Several years ago, the Governmental Accounting Standards Board (GASB), the FASB equivalent for state and local governments, issued new standards called Statements Number 43 and Number 45. For fiscal years beginning after December 2006, these require public employers to report their full retiree health liability to taxpayers just as corporations must do, creating similar pressure on them to deal with the problem.[58]

Some of them already have set up internal VEBAs or other pre-funding schemes to cope with the newly visible liability.[59] For example, of the 41 states that pay for some or all retiree health coverage, 30 use the pay-as-you-go method, while 11 pre-fund.[60] All those not pre-funding, including counties, municipalities, and other local entities, now must struggle with how to respond to the new accounting rules.

While the cost burden may be just as crushing on some public employers as it is on some private ones, the calculus of a response is different. To begin with, they don't pay taxes, so there's no tax advantage to them in setting up a tax-free trust like a VEBA. The political nature of governments also poses potential barriers to defeasance that companies don't face. The beneficiaries usually are voters, which gives them opportunities to object to such efforts that private-sector workers don't have. In addition, most states and larger counties and cities pay for Medicaid, public hospitals, and other public health programs that service the indigent. So if they cut out retiree health care and leave some retirees unable to cover medical expenses, they could find themselves picking up some of the tab anyway. Such concerns could make it difficult to emulate the auto makers and remove future hires from a retiree health plan.

Still, public employers do have powerful incentives to pre-fund retiree health through a VEBA or other plan, even if they don't sever the liability through a defeasance one. Those that continue the pay-as-you-go approach as large future obligations appear on their books may have to pay more to borrow if the bond market deems them less creditworthy and requires higher interest rates on future efforts to raise money in the capital markets. Pre-funding also could lead to future cost savings. Although setting up a trust requires higher outlays than continuing to make annual payments, as the trust starts to earn a return, the investment income will shoulder more of the cost. Eventually, pre-funding even could lead to lower yearly outlays.[61]

In addition, pre-funding allows public entities to post a lower liability on their books. It doesn't alter the actual amount they must pay out to retirees in future years. But GASB's accounting rules require governments using pay-as-you-go accounting to use short-term interest rates to calculate the obligation.[62] However, if they set aside money in a trust like a VEBA, they can use long-term rates, which typically are higher. Doing so cuts the size of the obligation, just as GM was able to do by using a 9% return assumption with the UAW instead of the 6% one it used with Wall Street. The rationale is that money not in a trust isn't necessarily going to be available for long-term investments that historically earn higher average returns.

These benefits must be weighed against the extra up-front outlays pre-funding requires. Such investments can be extremely expensive, up to ten times as much as what's required on a pay-as-you-go basis.[63] Public entities spend their annual budgets on education, police, or other services. Pre-funding retiree health requires them to divert what are usually scarce resources from these other needs, often essential ones, which many may be reluctant to do. Similarly, many governments also have other long-term obligations to fund, such as bonds floated to build roads or schools. They may not want to sink resources into retiree health liability instead of the others. In addition, the funds put in a VEBA trust can't be tapped should a budget deficit or other fiscal crisis hit in the future.

VEBA pre-funding also raises thorny issues of inter-generational equity amongst taxpayers. When a city or state uses pay-as-you-go accounting for retiree medical coverage, current taxpayers usually are paying for services enjoyed by prior generations of taxpayers. They're also shifting coverage costs for the workers serving them today onto tomorrow's taxpayers. No generation automatically comes out ahead or behind, since the cost each bears depends on medical inflation and the relative level of service provided in each era.[64]

A VEBA or other pre-funding scheme sets up a system in which each taxpayer generation comes closer to paying for the deferred compensation of the employees whose service they receive. This could be perceived as enhanced intergenerational equity. Of course, even if it is, one or more generations must pay the transition costs required for the initial pre-funding payments. It's also difficult to make accurate predictions about medical inflation and other assumptions, which could place too much cost on a particular generation.

For workers in the private sector, VEBA tax advantages could prove beneficial depending on the circumstances of their employment. Under current law, even organized workers' VEBA contributions are taxable if the trust is funded entirely by employees (although the earnings the trust makes accumulate tax free just like a retirement account).[65] One way to extend the full tax break to them would be for the employer to contribute, even if the amount were small. Failing that, it's possible that an employer could emulate GM and Goodyear and divert wage hikes and/or profit-sharing into a VEBA. Although such funds would come out of the pockets of employees, it would be by far the most tax-friendly way for them to save for retiree coverage. However, this model hasn't been tested, and it's possible that the Internal Revenue Service (IRS) or the Department of Labor would look askance at the idea.

Because federal law denies many of the VEBA tax advantages to nonunion workers, independent employee trusts are more difficult to set up for the majority of the workforce that today lack retiree coverage.[66] While nonunion employers can make contributions to a VEBA if they wish, there are strict limits on the amount.[67] And employee contributions are after-tax whether the employer contributes or the entire burden is borne by employees. Because of the latter limitation, the relatively small number of nonunion employer-pay-all VEBAs tend to have few participants.[68]

Conceivably, nonunion employers also could use GM-style wage or profit-sharing diversions to set up an employee-pay-all VEBA that would enjoy all the tax breaks of a union one. The IRS requires fully deductible VEBA contributions to be mandatory, so that employees can't choose between cash and the contribution. Typically, this is done through a union, which bargains rules that apply to all members.[69] One model in a nonunion setting could be for the employer to set up an automatic VEBA contribution with an opt-out provision, much like the new rules that took effect recently allowing employers to set up automatic payroll deductions for 401(k)s. Such an arrangement could be considered as mandatory as union membership, which is voluntary in most circumstances. However, this strategy also hasn't been tested and the IRS might not consider it mandatory enough to satisfy the requirement of a VEBA.

The most straightforward way to help workers save for retiree health care would be a change in federal tax law. Right now, the only tools available are defined-contribution pensions and defined-benefit plans like 401(k)s. But the money workers withdraw in retirement from such plans is taxed, even if spent on health care. There's nothing in federal tax law today like an employer medical plan or a Flexible Savings Account that retirees can use to purchase health care on a pre-tax basis. One option would be for Congress to pass a law allowing money spent on health care to be withdrawn on a pretax basis from pensions or 401(k)s. Another would be to allow pre-tax contributions to employee-pay-all VEBAs, which would serve much the same purpose. Of course, new tax breaks could cost many billions, depending on how extensively they were used. Major new tax burdens would likely prove politically divisive, especially in light of all the worries about Social Security and Medicare under funding,

The larger problem with any VEBA-like remedy for falling retiree health coverage is that it would do little to address the central issue both retired and active workers face regarding health care, which is the ever-increasing cost and lack of affordable coverage. Already, many Americans are uninsured or underinsured because they can't afford the premiums, co-pays, and deductibles. Giving them a new tax-free savings plan may be better than nothing, but it's not likely to be enough to offset double-digit medical inflation. And since many workers already are struggling with stagnant wages, they might be unable to save enough to fund a significant portion of their retiree health needs. As a result, VEBAs may be little more than a Band-Aid able to help some workers get by until a more comprehensive solution arrives.

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The Pensions and Capital Stewardship Project focuses on issues of retirement security, including employment-based retirement plans, and pension fund governance and management. It is also concerned with institutions, systems, and practices of pension fund investment that encourage capital markets and corporate policies to work more effectively for workers and the health and well-being of the community at large. The Project does this through research, education, and engagement with scholars and researchers, workers and unions, and practitioners.

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