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The New Retiree Health VEBAs

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CHAPTER 7

The New Retiree Health VEBAs

KATHRYN L. MOORE

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Synopsis

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§ 7.01 INTRODUCTION

Granted tax exempt status since 1928,[1] Voluntary Employees' Beneficiary Associations (VEBAs) have received considerable attention since the fall of 2007 when General Motors, Ford, and Chrysler reached separate landmark agreements with the United Auto Workers union pursuant to which the companies agreed to contribute billions of dollars to VEBAs in exchange for transferring their retiree health care liabilities to the VEBAs. Specifically, General Motors agreed to contribute $31.9 billion while Ford agreed to contribute $13.6 billion, and Chrysler agreed to contribute $11 billion.[2] Sometimes referred to as "defeasance" VEBAs,[3] these "new," "stand-alone" retiree health VEBAs, differ significantly from traditional VEBAs in that the employers transfer retiree health obligations to the VEBAs.

This article will examine this new trend in retiree health care financing. It will begin by providing a brief history of retiree health benefits. It will then describe the basic tax rules governing VEBAs. It will then discuss the difference between traditional retiree health VEBAs and the new retiree health VEBAs. Finally, it will discuss the advantages and limitations of the new retiree health VEBAs.

§ 7.02 BRIEF HISTORY OF RETIREE HEALTH BENEFITS

Employers first began to offer retiree health benefits on a wide scale in the late 1940s and the early 1950s.[4] When retiree health benefits were first introduced they were viewed as an inexpensive, "throw-away benefit" that was "lightly granted."[5] For most companies, those were plush years; they needed workers and had relatively few retirees.[6]

Although never universal, retiree health benefits became increasingly common through the 1980s. For example, while a majority of collective bargaining agreements

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[1] Revenue Act of 1928, Pub. L. No. 70-562, Sec. 103(16), 45 Stat. 791, 814 (1927-1929).

[2] Ellen O'Brien, *What Do the New Auto Industry VEBAs Mean for Current and Future Retirees?*, AARP Public Policy Institute INSIGHT on the Issues, Publication #I4 Table 1, at 7 (March 2008).

[3] *See* Aaron Bernstein, *Can VEBAs alleviate retiree health care problems?*, Capital Matters Occasional Paper Series, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School 7 (No. 1 April 2008) (referring to VEBAs as defeasance VEBAs because the companies are setting aside assets to void a debt obligation).

[4] Craig Douglas Hampton, Retiree Health Benefits and COBRA Issues, PLI Ord. No. D4-5249 (Jan.-Apr. 1994)

[5] David A. Pratt, *The Past, Present, and Future of Retiree Health Benefits*, 3 J. Health & Biomedical L. 103, 110 (2007).

[6] Selwyn Feinstein, *The Inevitable Happens: Making the Improbable Possible*, 4, 4, in An EBRI Special Report and Issue Brief No. 124: Retirement Security in a Post-FASB Environment (March 1992)

did not provide retiree health benefits in the early 1960s, by 1980 more than half of private collective bargaining agreements provided such benefits.[7] According to calculations by the Employee Benefit Research Institute, 43 percent of Americans aged 40 and over had retiree health coverage in 1988.[8] Covered individuals tended to work for large companies or public employers and were more likely to be unionized.[9]

Although retiree health benefits began as an inexpensive benefit, as health care costs soared in the 1980s, so too did the cost of retiree health benefits.[10] According to a survey by Wyatt Company, from 1987 to 1989, expenditures for active and retiree medical benefit plans by the nation's largest industrial companies increased at an annual rate of 21 percent, which was twice as fast as the national health expenditure growth rate, which was, in turn, increasing more than two percentage points faster than the Gross National Product.[11] "What had started out as a throw-away benefit had become a formidable commitment."[12]

Through the 1980's, retiree health coverage was financed on a pay-as-you go basis from current operations, and few companies acknowledged the liabilities on their books or set aside money to fund the benefits.[13] The Internal Revenue Code offered few tax favored ways to pre-fund retiree health benefits, and, unlike pensions, no law required that retiree health benefits be pre-funded.[14]

After studying the issue for a decade, the Financial Accounting Standards Board decided that pay-as-you-go accounting "ignores the measurement and recognition of the financial effects of promising to provide these benefits, and of the service that employees are rendering in exchange for those benefits."[15] Accordingly, in December 1990, the Financial Accounting Standards Board issued Statement No. 106, *Employer's Accounting for Postretirement Benefits Other Than Pensions* (FAS 106), to take

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[7] Douglas Sondgeroth, *High Hopes: Why Courts Should Fulfill Expectations of Lifetime Retiree Health Benefits in Ambiguous Collective Bargaining Agreements*, 42 B.C. L. Rev. 1215, 1219-20 (2001).

[8] Feinstein, *supra* note 6, at 4.

[9] Id. at 4.

[10] Daniel Keating, *Why the Bankruptcy Reform Act Left Labor Legacy Costs Alone*, 71 Mo. L. Rev. 985, 987 (2006).

[11] Feinstein, *supra* note 6, at 5. Retiree health costs continue to increase at a much higher rate than general inflation. Steven J. Sacher, *Issueman Tackles the New VEBAs*, BNA Pension & Benefits Reporter 820, 821 (4/08/2008) ("One of the benefits research houses recently reported that in the last 7 years, employer-sponsored health care costs have doubled while the over-all inflation rate has increased only 25 percent. . .").

[12] Feinstein, *supra* note 6, at 5.

[13] Id. at 4.

[14] Id.

[15] Id. at 5.

effect for fiscal years beginning after December 15, 1992.[16] FAS 106 requires employers to accrue the cost of anticipated future retiree health care obligations.[17] In September 2006, the Financial Accounting Standards Board issued FAS 158, which requires companies to move their retiree health costs out of their footnotes and into their balance sheets.[18]

When FAS 106 first went into effect, employers could report their unfunded liabilities as a one time expense or amortize them over a period of up to 20 years.[19] Not surprisingly, FAS 106 had a significant adverse impact on the balance sheet of many employers. For example, in 1992, General Motors reported a staggering one-time $20.8 billion charge and Ford Motor Company reported a $7.5 billion charge to comply with the rule.[20]

Since the issuance of FAS 106, many employers have terminated their retiree health benefits. According to one survey, while 46 percent of large employers offered medical benefits to early retirees in 1993, that number had fallen to 29 percent by 2005.[21] Over that same time period, the percentage of large employers offering benefits to Medicare-eligible retirees fell from 40 percent to 21 percent.[22] According to another study, over the last ten years, the percentage of private sector companies that provide retiree health benefits has fallen from 21.6 percent to 12.7 percent.[23] Most employers who have not terminated their retiree health benefits have reduced their promised benefits[24] and sought a tax-favored means of pre-funding the benefits.[25]

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[16] Id. at 5-6.

[17] Id. at 5-6.

[18] Kevin L. Bachler and David S. Hauptman, *New Solutions to Funding Retiree Medical Benefits*, 24 Journal of Compensation and Benefits 5 (January/February 2008)

[19] Feinstein, *supra* note 6, at 6; Pratt, *supra* note 5, at 121.

[20] Marilyn J. Ward Ford, *Broken Promises: Implementation of Financial Accounting Standards Board Rule 106, ERISA, and Legal Challenges to Modification and Termination of Postretirement Health Care Benefit Plans*, 68 St. John's L. Rev. 427, 432 (1994).

[21] Pratt, *supra* note 5, at 121.

[22] Id. at 121.

[23] Sacher, *supra* note 11, at 821.

Those private employers who chose to continue providing retiree health benefits did so by employing a variety of cost containment strategies: increasing retiree share of the costs (e.g., deductibles, coinsurance, premiums), indexing cost sharing provisions to inflation or cost trend rates, establishing annual/lifetime maximums or caps on employer contributions to the cost of health insurance, changing the formula for coordinating benefits with Medicare, tying benefit levels to length of service, providing reduced benefits to employees who retire early, changing from a defined benefit to a defined contribution plan, implementing managed care provisions (e.g., medical case management and pre-admission review), and eliminating early retirement or spousal/dependent coverage.

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§ 7.03 BASIC TAX RULES GOVERNING VEBAs

Unfortunately, the Internal Revenue Code offers few tax-favored vehicles through which to pre-fund retiree health benefits.[26] One of the few vehicles is the VEBA.

[1] Basic Requirements Applicable to VEBAs

A VEBA is a tax-exempt organization under section 501(c)(9) of the Internal Revenue Code that provides for the payment of life, sick, accident, or other benefits to members or their dependents or beneficiaries. In order to qualify as a VEBA, the following requirements must be satisfied: (1) the organization must be an employee's association; (2) membership must be voluntary; (3) the organization must provide life, sickness, accident, or similar benefits; and (4) the earnings must not inure to the benefit of a private shareholder or individual.[27]

A VEBA must be a legal entity that is separate from its member-employees or their employer.[28] The entity may take the form of a trust or corporation.[29] Early VEBAs were typically organized like corporations with articles of association and bylaws while modern VEBAs are more likely to be employee benefit plans coupled with trust agreements.[30]

Membership in a VEBA must be voluntary. According to the Treasury regulations, generally, membership will not be considered voluntary if there is a detriment to membership.[31] Membership, however, will be treated as voluntary even if employees covered under a collective bargaining agreement are required to join the VEBA.[32]

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[24] Ronald Kramer, Mark Casciari, *Government Accounting Standards Board (GASB) Statement No. 45 Makes Public Employers Revisit Retiree Health Insurance*, 37 Urb. Law. 427, 433 (2005).

[25] "[M]ost public companies with retiree health care liabilities have little or no pre-funding and face shortfalls of $321 billion, according to S&P in June 2006 (and approaching $400 billion according to Goldman Sachs in May of last year)." Samuel Halpern, *Funding Retiree Healthcare Liabilities,* 23 J. of Comp. and Benes. 4 (No. 2).

[26] For a discussion of the methods that may be used to pre-fund retiree health benefits, see, for example, Jeffrey D. Mamorsky, Health Care Benefits Law Sec. 9.04 (2008); Bachler and Hauptman, *supra* note 18; Anne P. Birge, *The Pending Crisis in Employer-Provided Health Benefits for Retirees: Are Tax Breaks for Employers the Answer?,* 19 NYU Rev. L. & Soc. Change 797 (1992).

[27] Treas. Reg. Sec. 1.501(c)(9)-1.

[28] Treas. Reg. Sec. 1.501(c)(9)-2(c)(1).

[29] Id.

[30] See Jeffrey C. McGuiness, Recent Prominent Agreements Renews Interest in VEBAs, H.R. Policy Association Memorandum 8-49 (May 1, 2008); David S. Dunkle, VEBAs and Other Self-Insured Arrangements, 395-2d Tax Management Portfolio A-20 (1993).

[31] Treas. Reg. Sec. 1.501(c)(9)-2(c)(2).

[32] Treas. Reg. Sec. 1.501(c)(9)-2(c)(2).

The membership of a VEBA must consist of "employees."[33] The term employee is defined broadly to include any individual who is considered an employee for employment tax purposes or for purposes of a collective bargaining agreement as well as anyone entitled to membership due to past employment, such as retirees, individuals who are on leave or have been laid off, and the surviving spouses and dependents of employees.[34]

The members of a VEBA must share an employment-related common bond.[35] The employment-related common bond will be satisfied if the employees work for a common employer (or affiliated employers), are covered under one or more collective bargaining agreements (and are provided benefits with respect to those agreements), or are members of a labor union or group of local affiliates.[36]

A VEBA cannot be a tool of the employer; there must be a wall of control between the employer and the VEBA. This requirement will be satisfied if the VEBA is controlled by its membership, or independent trustee(s) (such as a bank), or by trustees or other fiduciaries at least some of whom are designated by or on behalf of the membership.[37] This requirement will also be satisfied if the VEBA is an employee welfare benefit plan under section 3(1) of ERISA and as such is subject to ERISA's reporting and disclosure and fiduciary rules.[38] Similarly, this requirement will be satisfied if the VEBA is controlled by one or more trustees designated pursuant to a collective bargaining agreement.[39]

A VEBA must provide for the payment of "life, sick, accident, or similar benefits."[40] Sick benefits are benefits provided in the event of the illness of a member or

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[33] Treas. Reg. Sec. 1.501(c)(9)-2(a)(1).

[34] Treas. Reg. Sec. 1.501(c)(9)-2(b).

[35] Treas. Reg. Sec. 1.501(c)(9)-2(a)(1).

[36] Treas. Reg. Sec. 1.501(c)(9)-2(a)(1). The Treasury regulations also provide that "employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond." Id. In *Water Quality Ass'n Employees' Benefit Corp. v. U.S.,* 609 F. Supp. 91 (N.D. Ill. 1985), *rev'd*, 795 F. 2d 1303 (7th Cir. 1986), the IRS denied exempt status to a VEBA because the Association members did not work in the same geographic locale. The Seventh Circuit rejected the IRS' imposition of a geographic limitation on membership in the VEBA. Id. at 1304. Despite this decision, the Treasury Department has issued proposed regulations under section 501(c)(9) which liberalize the geographic limitation but do not entirely eliminate it. See Prop. Treas. Reg. Sec. 1.501(c)(9)-2(d) (creating three-state safe harbor and establishing a subjective discretionary standard).

[37] Treas. Reg. Sec. 1.501(c)(9)-2(c)(3).

[38] Treas. Reg. Sec. 1.501(c)(9)-2(c)(3).

[39] Treas. Reg. Sec. 1.501(c)(9)-2(c)(3).

[40] IRC Sec. 501(c)(9).

dependent.[41] Benefits may be provided by reimbursing members or members' dependents for amounts expended on account of an illness, or by paying premiums to a medical benefit or health insurance program.[42]

In order to qualify for tax exempt status, no part of the earnings of a VEBA may inure to the benefit of any private shareholder or individual other than through the payment of permissible benefits.[43] A facts and circumstances test is used to determine whether there is prohibited inurement.[44] Prohibited inurement may include the disposition of property or the performance of services for less than the greater of the fair market value or cost to the VEBA.[45]

[2] Nondiscrimination Requirements

Section 505 of the Internal Revenue Code imposes nondiscrimination requirements on VEBAs. Specifically, section 505(b)(1) requires that coverage be nondiscriminatory and that benefits be provided on a nondiscriminatory basis. The nondiscrimination requirements do not apply to a VEBA that is part of a plan maintained under a collective bargaining agreement.[46]

[3] Limitations on Employers' Deductions for Contributions to VEBAs

Sections 419 and 419A of the Internal Revenue Code severely limit most employers' ability to deduct contributions to pre-fund retiree health benefits through a VEBA. In essence, sections 419 and 419A limit an employer's deduction to the amounts necessary to fund health benefits on a current basis (including administrative costs) plus contributions to a reserve funded over the working lives of the covered employees and actuarially determined on a level basis as necessary to provide retiree health benefits (based on current medical costs). In addition, section 512 imposes tax on the VEBA's "unearned income" to the extent contributions exceed these limitations, disregarding any reserve for post-retirement medical benefits. The limitations, however, do not apply to a VEBA under a collective bargaining agreement.

Specifically, under section 419 contributions to a welfare benefit fund, including a VEBA,[47] are deductible in the year paid, to the extent that the contributions do not

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[41] Treas. Reg. Sec. 1.501(c)(9)-3(c). For the definition of life benefits, see Treas. Reg. Sec. 1.501(c)(9)-3(b). For the definition of other benefits, see Treas. Reg. Sec. 1.501(c)(9)-3(d).

[42] Treas. Reg. Sec. 1.501(c)(9)-3(c).

[43] Treas. Reg. Sec. 1.501(c)(9)-4(a).

[44] Treas. Reg. Sec. 1.501(c)(9)-4(a).

[45] Treas. Reg. Sec. 1.501(c)(9)-4(a).

[46] IRC Sec. 505(a)(2).

[47] See IRC Sec. 419(e)(3)(A) (defining welfare benefit fund to include a VEBA).

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exceed the VEBA's "qualified cost" for the taxable year.[48] The term "qualified cost," in turn, is defined as the sum of (1) the "qualified direct cost" for the taxable year, plus (2) any addition to a "qualified asset account" for the year, subject to the limitation set forth in section 419A(b).[49] This sum must be reduced by the fund's after-tax income for the taxable year.[50]

The term "qualified direct cost" is defined as the aggregate amount (including administrative expenses) which would have been allowable as a deduction to the employer if the benefits were directly provided by the employer and the employer was on a cash method of accounting.[51] In essence, the qualified direct cost is "the cost of providing benefits on a pay-as-you go basis during the taxable year;"[52] i.e., the cost of current benefits plus administrative expenses.

Section 419A(a)(2) defines a "qualified asset account" to include any account consisting of assets set aside to provide for the payment of medical benefits. Additions to the qualified asset account are then limited to (1) the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year),[53] plus (2) administrative expenses, plus (3) certain additional reserves for post-retirement medical benefits.[54] With respect to the reserves for post-retirement medical benefits, the account limit may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis as necessary to provide retiree health benefits (determined on the basis of current medical costs).[55] In the absence of an actuarial certification, the account limit is limited to 35 percent of the qualified direct costs (other than insurance premiums) for the preceding taxable year with respect to medical benefits.[56]

As noted above, if employer contributions exceed the plan's qualified cost, the employer may not deduct them in the year made.[57] In addition, contributions that exceed the plan's qualified cost are subject unrelated business income tax.[58]

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[48] IRC Secs. 419(a) & (b).

[49] IRC Sec. 419(c)(1).

[50] IRC Sec. 419(c)(2).

[51] IRC Sec. 419(c)(3)(A).

[52] Scott J. Macey and George F. O'Donnell, *Retiree Health Benefits — The Divergent Paths*, NYU Review of Employee Benefits and Executive Compensation 8-31 (2003).

[53] IRC Sec. 419A(1)(a).

[54] IRC Sec. 419A(2)(A).

[55] IRC Sec. 419A(c)(2)(A).

[56] IRC Sec. 419A(c)(5)(B)(ii).

[57] See IRC Sec. 419(b).

[58] IRC Sec. 512(a)(3).

Thus, Section 419 and 419A impose considerable restrictions on an employer's ability to pre-fund retiree health benefits through a VEBA on a tax-favored basis.[59] The account limits, however, do not apply in the case of a separate welfare fund under a collective bargaining agreement.[60] Thus, employers can and do use VEBAs to prefund retiree health benefits for union employees.[61]

§ 7.04 TRADITIONAL VERSUS "NEW" RETIREE HEALTH VEBAs

Employers may use VEBAs as a tax-favored vehicle for pre-funding retiree health benefits for union employees. Under the traditional "company-run" arrangement, the employer makes a tax-deductible contribution to the VEBA,[62] and the VEBA earns tax-free interest. Funds are then withdrawn from the VEBA to pay for claims or other benefit-related expenses; however, the employer ultimately remains liable for any promised benefits.

The "new" "stand-alone" retiree health VEBAs differ significantly from traditional VEBAs[63] in that the employer transfers its entire retiree health obligation to the VEBA.[64] Typically, the employer makes a large fixed contribution to the VEBA in exchange for transferring the employer's benefit liability to the VEBA.[65]

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[59] There is, however, some flexibility with respect to pre-funding benefits for current retirees. In Wells Fargo & Co. v. Commissioner, 120 T.C. 69 (2003), the tax court held that the individual level premium cost method permits an employer to deduct contributions to a VEBA equal to the entire present value of future health benefits for current retirees in the year it establishes a VEBA reserve to fund the retiree health benefits.

[60] IRC Sec. 419A(f)(5)(A). In addition, the account limits do not apply to tax-exempt and governmental employers. See IRC Sec. 512(a)(3)(E)(iii).

[61] Ellen E. Schultz and Theo Francis, *What Might GM Trust Fund Mean for Workers Elsewhere?*, The Wall Street J. A14 (Sept. 27, 2007) (noting that VEBAs are typically established by companies with large union work forces because they are not subject to the 419A deduction limits).

[62] VEBAs may be funded by mandatory employee contributions, employer contributions, or a combination of both. Indeed, when VEBAs were first granted tax exempt status, at least 85 percent of the association's income had to come from member contributions. See Revenue Act of 1928, Pub. L. No. 70-562, Sec. 103(16), 45 Stat. 791, 814 (1927-1929).

[63] In 2007, there were a total of 12,128 VEBAs. Internal Revenue Service Book, Table 25, at 54 (2007). Little more than 25 of those 12,128 VEBAs were stand-alone retiree health VEBAs. See Segal, Study of Retiree Health VEBAs, Survey (Winter 2008).

[64] O'Brien, *supra* note 2, at 6 ("Effective January 1, 2010 (or when any appeals or court challenges are exhausted), responsibility for providing and paying for retiree health benefits will be shifted permanently to new retiree plans funded by VEBA trusts.").

[65] There are three basic methods for pre-funding retiree health benefits through a "new" VEBA. Under the first, individual account plan, contributions go into each employee's own individual account, and the amount available for distribution is simply the total contributions and any earnings or losses on those contributions. This method is essentially a defined contribution health savings account. Under the second,

Daniel Keating has described the arrangement as

> analogous to how the legal system dealt with companies' mass-tort liabilities during the 1980s and 1990s. In those cases, the companies would admit that they had future liabilities that were significant. The problem was, these companies could not successfully operate as ongoing entities with the size and scope of those liabilities still unknown. If these giant uncertain future liabilities would force a company to liquidate in the short-term, then everyone would lose, including future victims. The solution was to shift a portion of the company's assets into a separate financial entity that would be solely responsible for that category of liability. In that way, future victims would have some source of funds from which to recover, and the companies could continue to operate without the specter of unlimited future liability holding them back.[66]

Although the VEBA created by the UAW agreements with the Big Three is the largest new VEBA,[67] it is not the first. According to a study by Segal Company, the oldest ongoing retiree health care VEBA is more than 25 years old, and there have been another five in existence for at least 15 years.[68] Nevertheless, most new VEBAs were recently created.[69]

§ 7.05 ADVANTAGES OF THE NEW RETIREE HEALTH VEBAs

The advantages of the new VEBAs to employers are relatively straightforward and obvious. The advantages of the new VEBAs to retirees are a bit more subtle.

[1] Advantages of the New VEBAs to Employers

From the employer's standpoint, the most significant advantage of the new VEBA is that it permits the employer to transfer its liability for retiree health benefits to the

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commingled trust, method, contributions go into a pooled account at a set level for each employee, and the benefit is a maximum monthly amount that pays for retiree medical premiums or other qualified expenses. This method is similar to a defined benefit plan. Under the third, hybrid plan, a defined contribution (often a one-time, lump-sum employer contribution) is contributed to a commingled trust, and the amount available for distribution depends on the investment experience of the trust. Unlike the second method, the trust provides and pays for retirees' health care coverage under a traditional health plan rather than providing a fixed monthly dollar amount to reimburse employees for qualified expenses. Michael I. Richardson and Daniel R. Salemi, *Funding Postretirement Health Benefits Through a VEBA*, Benefits & Compensation Digest 26, 28-29 (Sept. 2007).

[66] Daniel Keating, *Harsh Realities and Silver Linings for Retirees,* 15 Am. Bankr. Inst. L. Rev. 437, 452 (2007).

[67] See O'Brien, *supra* note 2, at 5.

[68] See Segal, *supra* note 63.

[69] See id. (noting that almost one-third of the VEBAs were started in 2007, or would be started in 2008).

VEBA. Moreover, in many, if not all, instances,[70] the employer may transfer significantly less money (and other assets) to the VEBA than the present value of its current obligation.[71] For example, GM promised to contribute $31.9 billion to a VEBA in exchange for the transfer of a $46.7 billion retiree health care liability.[72] Ford agreed to contribute $13.6 billion to transfer a $23.7 billion liability, and Chrysler promised to pay $11 billion in exchange for a $18.3 billion liability.[73]

As discussed in section 7.02 above, FAS 106/FAS 158 require employers to accrue the cost of anticipated future retiree health care obligations on their balance sheets.[74] Transferring the liability for retiree health benefits to a VEBA permits the employer to remove the liability from its balance sheet, and if the liability is significant enough and the transfer at a steep enough discount,[75] it may improve the employer's credit rating and make future borrowing both cheaper and easier.[76]

[2] Advantages of the New VEBAs to Retirees

Although the advantage to the employer of transferring its retiree health liability to a VEBA for significantly less than its projected cost is readily apparent, it is less clear why unions — and employees and retirees — would agree to these transfers. In a letter

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[70] See Sacher, *supra* note 11, at 823 ("And obviously the company is not going to transfer assets equal to the present value of the OPEB liability. If it had to transfer that much, it would not have agreed to the deal. So it's going to transfer less assets.").

[71] "The automakers were interested in funding retiree health care and eliminating their liabilities, but only if they could do so at a substantial discount — which is what they got." O'Brien, *supra* note 2, at 9.

[72] Id. at 7 Table 1.

[73] Id. at 7 Table 1.

[74] Currently, the aggregate unfunded liability for other post employment benefits, which are made up principally of retiree medical costs, is reported to be $292 billion for the Standard and Poor 500. Bachler and Haputman, *supra* note 18.

[75] For example, GM's total VEBA funding only covered 68 percent of its projected liabilities while Ford only covered 57 percent of its projected liabilities, and Chrysler covered 60 percent of its projected liabilities. O'Brien, *supra* note 2, at 7 Table 1.

[76] "When Goodyear announced the creation of its VEBA, rating agency Moody's Investors Services noted that the transaction would have a positive effect on the "qualitative factors" that are used to calculate credit ratings, meaning that by removing the liabilities from its balance sheet, Goodyear helped to bolster its credit score." Stephen Taub, VEBA is a New Buzzword for Retirees, CFO.com (Sept. 27, 2007), available at http://www.cfo.com/printable/article.cfm/9889645?f=options. *See also* Marie Leone, *How Benefit Shifts Boost Credit Ratings*, CFO.com (July 11, 2007), available at http://www.cfo.com/printable/article.cfm/9465441/c_9465936?f=options.

The new VEBAs may even increase the company's stock price. "Some stock analysts predicted a doubling of G.M.'s share price if the company got its retiree health care VEBA." O'Brien, *supra* note 2, at 1.

to retirees, the UAW outlined the two principle advantages to retirees of this arrangement: (1) it protects against the employer's claim that it is legally entitled to unilaterally modify — or even terminate — retiree health benefits; and (2) it protects against the risk that the company's financial difficulties may result in bankruptcy.[77]

[a] Protection Against Employer's Right to Modify or Terminate Retiree Health Benefits

ERISA requires that pension benefits be vested,[78] but does not impose such a requirement on retiree health benefits.[79] Rather, the Supreme Court has repeatedly stated, "Employers or other plan sponsors are generally free under ERISA, for any reason at any time, to adopt, modify, or terminate welfare plans."[80]

Although ERISA does not require that retiree health benefits be vested, employers may contractually agree to the vesting of such benefits. Over the last twenty years or so, retirees have claimed that employers contractually agreed to the vesting of retiree health benefits in a multitude of cases challenging the employer's decision to unilaterally modify or terminate retiree health benefits.[81] How the courts resolve the issue generally depends on three factors: (1) whether or not the benefits were collectively bargained; (2) the circuit in which suit was brought; and (3) whether the employer expressly reserved the right to alter, amend, or terminate retiree health benefits.[82]

Generally, courts are more likely to find vested retiree health benefits in cases involving collective bargaining agreements than in cases outside the collective bargaining context.[83] For example, in one of the first and most influential cases regarding the vesting of retiree health benefits, the Sixth Circuit held that in the case of collectively bargained benefits, there is a presumption that retiree health benefits

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[77] Tim Higgins, Ex-Blues Boss to oversee VEBA, Detroit Free Press (April 10, 2008)

[78] ERISA Sec. 203(a).

[79] ERISA Sec. 201(1).

[80] *Lockheed Corp.v. Spink*,517 U.S. 882, 890 (1996); *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 78 (1995).

[81] Retirees have also raised breach of fiduciary and promissory and/or equitable estoppel claims. For a more detailed discussion of the law and cases, see, for example, ABA Employee Benefits Law 1058-70 (2d ed. 2000) & 2007 Cumulative Supplement 995-1007; *Who Killed Yard-Man*?, Jones Day Commentary (April 2007); Macey and O'Donnell, *supra* note 52, at 8-10–8-21.

[82] Steven J. AS, *Retiree Health Benefit Cutbacks: Issueman Attempts to Untangle the Web*, 20 BNA Pens. & Benefits Rep. 1242 (June 7, 1993). *See also* Macey and O'Donnell, *supra* note 52, at 8-19 (summarizing the law in a similar fashion).

[83] See Macey and O'Donnell, *supra* note 52, at 8-19 ("many of the cases have distinguished between bargained for and non-bargained for benefits and have applied much greater restrictions to amending or terminating the former than the latter.").

will continue beyond the expiration of the collective bargaining agreement.[84] This presumption, referred to as the Yard-Man inference, does not extend to non-collectively bargained benefits. Indeed, with respect to non-union employees, the Sixth Circuit has declared that "an employer's commitment to vest [retiree health] benefits is not to be inferred lightly; the 'intent to vest 'must be found in the plan documents and must be stated in clear and express language.' "[85]

While the Yard-Man inference makes it more likely that the Sixth Circuit will find vested retiree health benefits under collective bargaining agreements, not all Circuits have accepted the inference. Specifically, the approach has been adopted by the First,[86] Fourth,[87] and Eleventh[88] Circuits but has been rejected by the Third,[89] Fifth,[90] Seventh,[91] and Eighth[92] Circuits.

Whether a case arises under a collective bargaining agreement or not, courts will uniformly permit an employer to terminate retiree health benefits if the unambiguous terms of the agreement or plan documents permit the employer to terminate the benefits.[93] On the other hand, if the terms of the agreement or plan document are ambiguous, courts will generally consider extrinsic evidence to determine whether the

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[84] UAW v. Yard-Man, Inc., 716 F.2d 1476, 1482 (6th Cir. 1983), *cert. denied*, 465 U.S. 1007 (1984). For a detailed discussion of Yard-Man and an argument that the Yard-Man inference should be retained, see Douglas Sondgereth, *Hight Hopes: Why Courts Should Fulfill Expectations of Lifetime Retiree Health Benefits in Ambiguous Collective Bargaining Agreements,* 42 B.C. L. Rev. 1215 (2001).

[85] Sprague v. Gen. Motors Corp., 133 F.3d 388, 400 (6th Cir.), *cert. denied*, 524 U.S. 923 (1998), *quoting*, Wise v. El Paso Natural Gas Co., 986 F.2d 929, 937 (5th Cir.), *cert. denied*, 510 U.S. 870 (1993).

[86] Steelworkers v. Textron, Inc. 836 F.2d 6, 9 (1st Cir. 1987).

[87] Keffer v. H.K. Porter Co., 872 F.2d 60, 64 (4th Cir. 1989).

[88] Steelworkers v. Connors Steel Co., 855 F.2d 1499, 1505 (11th Cir. 1988).

[89] Auto Workers v. Skinner Engine Co., 188 F.3d 130, 139-41 (3d Cir. 1999).

[90] Int'l Assoc. of Machinists & Aerospace Workers v. Masonite Corp., 122 F.3d 228, 231-32 (5th Cir. 1997); Paperworkers v. Champion Int'l Corp., 908 F.2d 1252, 1261 n.12 (5th Cir. 1990).

[91] Rossetto v. Pabst Brewing Co., 217 F.3d 539, 543-44 (7th Cir. 2000), *cert. denied*, 531 U.S. 1192 (2001).

[92] See Anderson v. Alpha Portland Indus., Inc., 836 F.2d 1512, 1517 (8th Cir. 1988), *cert. denied*, 489 U.S. 1051 (1989).

[93] See ABA Employee Benefits Law, *supra* note 81, at 1061, 1065 ("If the CBA unambiguously allows retiree benefits to be terminated, the court's inquiry ends. . . . In general, absent unambiguous language creating a substantive entitlement, it is presumed that nonbargained benefits are not vested for life."); Macey and O'Donnell, *supra* note 52, at 8-15 ("if plan documents clearly provide for vesting of such benefits, then that vesting will generally be enforced"). *See also* In re Doskocil Cos., 130 B.R. 870, 873 (Bank. D. Kan. 1991) ("Absent proof of fraud, the Circuits have ruled unanimously that if the SPD is unambiguous in allowing modifications of welfare benefits, the employer will be permitted to make changes.").

employer has the right to unilaterally modify or terminate benefits.[94] The courts do not follow a uniform approach in cases of ambiguity.[95] Indeed, one commentator has declared that the "diversity of theories and opinions throughout the federal court system makes it difficult for employers [and employees] to fully assess their situations regarding existing rights of modification or termination of retiree health benefits."[96]

The new VEBAs protect retirees against the risk that employers may try to unilaterally modify or terminate retiree health benefits. They protect retirees against the cost of litigation as well as the risk that a court may find that the employer has the right to unilaterally amend or terminate the benefits.

[b] Protection Against Risk of Bankruptcy

Even if a court were to hold that an employer may not unilaterally amend or terminate retiree health benefits, such a victory could ultimately prove to be a Pyrrhic one if the employer were to go bankrupt. As the Sixth Circuit has noted, "[i]t 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."[97]

Generally, an employer may file for bankruptcy protection under either Chapter 7 or Chapter 11 of the Bankruptcy Code. If the employer files for bankruptcy under Chapter 7, the company will be liquidated, and all retiree health benefits will be terminated along with all jobs.[98] If the employer files for bankruptcy under Chapter 11, the Bankruptcy Code provides retirees with some protection against the modification or termination of retiree health benefits.

Specifically, Section 1114 of the Bankruptcy Code, added by the Retiree Benefits

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[94] See ABA Employee Benefits Law Supplement, *supra* note 81, at 996 & 1000-01; ABA Employee Benefits Law, *supra* note 81, at 1061 & 1065. *See also* Sondgeroth, *supra* note 84, at 1230 ("If, instead, the language is ambiguous as to whether the benefits were intended to vest, courts allow both sides to introduce extrinsic evidence to clarify the parties' intentions at the formation of the agreement.").

[95] For a discussion of the cases, see ABA Employee Benefits Law, *supra* note 81, at 1061-69; ABA Employee Benefits Law Supplement, *supra* note 81, at 995-1004.

[96] Macey and O'Donnell, *supra* note 52, at 8-20.

[97] UAW v. General Motors Corp., 497 F.3d 615, 632 (6th Cir. 2007).

[98] See Sacher, *supra* note 11, at 822 ("The retiree health obligation is contractual. In a bankruptcy, contractual obligations are discharged, retiree health like others. Of course if the company is in a Chapter 7 liquidation proceeding, all benefits are ended along with all jobs."); Keating, *supra* note 10, at 1000 ("Returning again to the *Horizon* case, the choice facing the bankruptcy judge was essentially to: (1) let the company liquidate, in which case the retirees would get nothing, and all of the workers would lose their jobs. . . .").

Bankruptcy Protection Act of 1988,[99] provides that notwithstanding any other provision of Title 11, a debtor "shall timely pay and shall not modify any retiree benefit"[100] unless either (1) the court, on motion of the trustee and after notice and hearing, has ordered modification of such payments; or (2) the debtor and authorized representative of the recipients of the benefits have agreed to modification of the benefits.[101] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[102] amended Section 1114 of the Bankruptcy Code to extend protection to pre-petition reductions in retiree benefits. Specifically, Section 1114(l) provides that if an employer modifies retiree benefits during the 180-day period prior to filing for bankruptcy and the employer was insolvent on that date, the court must order reinstatement of the original retiree benefits unless the court finds that the balance of the equities clearly favors the modification.[103]

Interpretation of the scope of Section 1114 varies from jurisdiction to jurisdiction. Some courts have held that Section 1114 does not apply if the employer had the right prior to bankruptcy to terminate retiree benefits.[104] On the other hand, at least one court has rejected that view and held that all debtors must comply with Section 1114 regardless of whether they had the right, prior to filing the bankruptcy petition, to unilaterally terminate retiree benefits.[105]

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[99] Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended at 11 U.S.C. Sec. 1114 (1988)).

[100] Retiree benefits are defined to include "payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, . . . under any plan, fund, or program through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title [title 11]." 11 U.S.C. Sec. 1114(a).

[101] 11 U.S.C. Sec. 1114(e). For critiques of Section 1114, see Daniel Keating, *Bankruptcy Code Section 1114: Congress' Empty Response to the Retiree Plight*, 67 Am. Bankr. L.J. 17 (1993); Leslie T. Gladstone, *Retiree Benefits Bankruptcy Protection Act of 1988: Welfare Benefits in Need of Reform*, 65 Am. Bankr. L. J. 27 (1991).

[102] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 34 (April 20, 2005).

[103] 11 U.S.C. Sec. 1114(l).

[104] *See*, *e.g.,* In re North Am. Royalties, Inc., 276 B.R. 860, 866-68 (Bank. E.D. Tenn. 2002); In re Raytech Corp., 242 B.R. 222, 225 n.3 (Bank. D. Conn. 1999); In re Doskocil Cos., 130 B.R. 870, 872 (Bank. D. Kan. 1991); In re Chateaugay Corp., 111 B.R. 399 (S.D.N.Y. 1990), *aff'd*, 945 F.2d 1205 (2d Cir. 1991), *cert. denied sub nom.,* UMW 1974 Bene. Plan and Trust v. LTV Steel, 502 U.S. 1093 (1992). *See also* Keating, *supra* note 101, at 41-42 (contending that despite Section 1114, debtor can terminate contract as allowed by its terms).

[105] *See* In re Farmland Indus., Inc., 294 B.R. 903 (Bank. W.D. Mo. 2003). *See also* Susan J. Stabile, *Protecting Retiree Medical Benefit in Bankruptcy: The Scope of Section 1114 of the Bankruptcy Code*, 14 Cardozo L. Rev. 1911 (1993) (arguing that Section 1114 should be interpreted broadly to apply to all

To the extent that Section 1114 applies, it protects retirees against the risk that an employer may unilaterally reduce or eliminate retiree health benefits during a Chapter 11 bankruptcy proceeding.[106] Section 1114, however, does not ensure that retiree health benefits will not be reduced or terminated. Section 1114 requires the employer to bargain with the retirees' representative prior to reducing or eliminating retiree benefits.[107] If the employer and retirees' representative fail to reach agreement, Section 1114 authorizes the court to enter an order providing for the modification of retiree benefits if the court finds that "such modification is necessary to permit the reorganization of the debtor and assure that all creditors, the debtor, and all of the affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities."[108]

Thus, employers in bankruptcy proceedings can and frequently do seek modification of retiree benefits in Chapter 11 proceedings,[109] and those modified benefits are often "a pale shadow of the former benefits."[110] For example, in perhaps one of the most publicized recent cases, the court permitted Horizon Natural Resources Company to

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debtors, regardless of whether they had a right to unilaterally modify benefits prior to filing for bankruptcy); J. Keith Bryan, *Expiration of Retiree Benefit Plans During Reorganization: A Bitter Pill for Employees*, 9 Bankr. Dev. J. 539 (1992) (arguing that Section 1114 should be interpreted to cover retiree benefit plans even after collective bargaining agreement expires).

There is also some question whether Section 1114 extends to statutory benefits. *Cf.* In re Horizon, 316 B.R. 268, 275-79 (holding that Section 1114 applies to benefits under the Coal Act).

[106] *See* S. Rep. No. 119, 100th Cong., 2d Sess. 5, *reprinted in* 1988 U.S.C.A.A.N. 683, 686 (explaining that purpose of Section 1114 is to avoid unilateral changes in retiree benefits plans by companies undergoing reorganization).

[107] 11 U.S.C. Sec. 1114(f)(1).

[108] 11 U.S.C. Sec. 1114(g)(3). Before a court may make such an order, the trustee must first make a proposal to the employees' representative "which provides for those necessary modifications in the retiree benefits that are necessary to permit the reorganization of the debtor and assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably." 11 U.S.C. Sec. 1114(f)(1)(A) & (g)(1).

[109] According to a GAO study of 115 employers that filed for chapter 11 bankruptcy between October 17, 2004, and October 17, 2006, five of the eighteen employers who offered retiree health benefits sought a court order to modify their retiree health benefits, and several other employers had modified their benefits prior to filing for bankruptcy. United States Government Accountability Office, *Employer-Sponsored Benefits: Many Factors Affect the Treatment of Pension and Health Benefits in Chapter 11 Bankruptcy*, GAO-07-1101 Table 25, at 32 (September 2007).

[110] *See* Sacher, *supra* note 11, at 822 ("[I]f a company maintained retiree health benefits before it filed under Chapter 11, the federal bankruptcy code requires it to bargain with the retirees for replacement benefits. Usually, those benefits are a pale shadow of the former benefits."). *Cf.* Keating, *supra* note 66, at 438 ("Despite a special section of the Bankruptcy Code intended to protect those benefits [Section 1114], and despite an amendment to that Bankruptcy Code section as part of the 2005 bankruptcy reform bill, retirees continue to lose promised medical benefits in many chapter 11 cases.")

sell its assets free and clear of a successor clause that would have required the buyer to assume the company's retiree health care obligations.[111] As a result, the retiree health benefits were essentially eliminated.[112]

Employers who seek to modify retiree health benefits in bankruptcy proceedings may create one of the new retiree health VEBAs to fund retiree health benefits. For example, two of the five employers who sought a court order to modify retiree health benefits in a Government Accountability Office study established a VEBA to fund retiree health benefits.[113] And, according to Segal Company's VEBA study, 10 of the 25 stand-alone VEBAs it studied had been formed as a result of bankruptcy.[114] Indeed, according to the Segal study, "[h]istorically, bankruptcy has been the most common reason for the formation of retiree health VEBAs, although collective bargaining is becoming a more prominent trigger."[115]

The new retiree health VEBAs protect retirees against the risk of liquidation because the employer's creditors cannot reach the assets in the VEBAs.[116]

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[111] In re Horizon Natural Resources Co., 316 B.R. 268, 282 (Bank. E.D. Ky. 2004).

[112] *See* Keating, *supra* note 66, at 449 ("What made the Horizon case so noteworthy is that it demonstrated that even in the absence of a piecemeal liquidation of the company's assets, retirees could nevertheless lose all of their promised and vested retiree benefits.").

In *In re Horizon*, the court noted that retiree health benefits were not entirely eliminated: "the hourly-rate retirees may be eligible for benefits under the 1993 Plan; and the Coal Act retirees will continue to receive limited (catastrophic) medical coverage for a period of time and may then be eligible for benefits under the 1992 Plan." Id. at 283. Funding and other limitations, however, severely limited the value of the remaining benefits. *See id*. at 273 & 274 (noting that financial consultant was of the opinion that obligation to make contributions to 1992 plan would terminate when employer goes out of business and that witnesses testified that adding hourly rate retirees to 1993 plan could "collapse" the already underfunded plan). *See also* Sharon Cohen, *Health Benefits Vanish in Bankruptcy Court*, L.A. Times 23 (Dec. 19, 2004) (noting that according to union's research director smaller union funds would probably be out of money by next year).

[113] GAO, *supra* note 109, at 33.

[114] Segal, *supra* note 63, at 1.

[115] Id. at 1. *See also* Keating, *supra* note 66, at 452 ("[A]n even bigger trend that is happening lately is section 1114-like modifications to retiree medical benefits without the need for an employer to file bankruptcy at all. The most common modifications under these scenarios involve a shift in retiree benefits from a promise owed by the employer for the future to a present fixed payment into a Voluntary Employee Benefit Association (VEBA) form which retirees will need to cover their benefit costs down the road.").

[116] *See* Keating, Silver Linings, at 454 & 460 ("Goodyear was happy because it shed this uncertain liability that was projected to cost $1.2 billion, and the union was happy because now if Goodyear files for bankruptcy, there is no way that any other creditors can get at the retiree benefit money since it will be separate and independent from Goodyear's bankruptcy estate. . . .The beauty of the VEBA arrangements that are becoming increasingly common for providing retiree health benefits is that even if the company later files for bankruptcy, none of the company's creditor's can attach funds that are in the

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§ 7.06 LIMITATIONS OF THE NEW RETIREE HEALTH VEBAs

Although the new retiree health VEBAs have their advantages, they are not without their limitations.

[1] The New VEBAs Do Not Guarantee that Retiree Health Benefits Will Not Be Reduced or Eliminated

"Unlike a traditional or defined-benefit VEBA, a stand-alone VEBA involves no guarantee by the employer of a certain level of benefits."[117] Rather, typically the employer promises to transfer a certain amount of money and/or other assets to the VEBA, and if the assets in the VEBA and earnings or losses on those assets are insufficient, benefits may be reduced or even eliminated.

If a new VEBA is initially underfunded, benefits will almost certainly be reduced or eliminated. For example, in 1992, Caterpillar, a company based in Peoria, Illinois, imposed a cap on retiree health benefits for individuals who retired after January 1, 1992,[118] and in 1998, the company agreed to contribute $35 million to a VEBA to pay for expenses incurred by post-January 1, 1992 retirees that exceeded the newly implemented cap.[119] The company made no promise to provide additional or future funding to the VEBA.[120] The VEBA was designed to and did last about six years, until the next contract negotiation.[121] When the VEBA's assets ran out, the company began charging retirees and their surviving spouses for a portion of their medical care.[122]

Even if a VEBA is structured to be "fully funded" at the outset, health care costs may be higher than expected and/or earnings may be lower than anticipated, and benefits may have to be reduced or even eliminated as a result.[123] For example, in calculating the level of funding needed for the new GM VEBA to be fully funded, the

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retiree health-care VEBA"). *See also* Bernstein, *supra* note 3, at 18 ("such trusts offer a fair degree of insulation form employer bankruptcy, depending on how well funded the trust is and whether it has employer stock").

[117] Bernstein, *supra* note 3, at 7.

[118] Winnett v. Caterpillar, Inc., 496 F. Supp. 2d 904, 912-13 (2007)

[119] Id. at 913.

[120] Id. at 913.

[121] O'Brien, *supra* note 2, at 5.

[122] 496 F. Supp. 2d at 907. "[B]y the time a new contract was negotiated in 2004, a highly profitable Caterpillar had agreed to share with retirees the cost of health coverage above the caps — with the company paying 60 percent of the costs above the cap and retirees paying 40 percent." O'Brien, *supra* note 2, at 11.

[123] "The major risks to U.A.W. retirees derive from the unpredictability of both health care costs and investment returns. If returns don't meet expectations or costs grow more rapidly than projected, the trust will not be sufficient to meet future obligations." O'Brien, *supra* note 2, at 8.

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union and GM agreed to assume an average annual 5 percent increase in health care costs.[124] How realistic an assumption that is is subject to debate. In recent years, health care costs have generally increased at a much higher rate than five percent. For example, "[e]mployer spending on retiree health care increased by more than 16 percent in 2002 and continued to grow at double-digit rates through 2005.[125] "Since 2001, premiums for family coverage have increased 78%, while wages have only gone up 19% and inflation climbed 17%."[126] On the other hand, health care costs dropped to just 6.1 percent in 2007,[127] and, using its intermediate assumptions, the Medicare Board of Trustees projects that health care costs will increase at an annual average rate of 5.1 percent over the next seventy-five years.[128]

[2] Depending on How the New VEBAs are Funded, Retiree Health Benefits May Still be Tied to the Fortunes of the Company

As discussed in section 7.05[2][b] above, one of the advantages of the new retiree health VEBAs is that they set aside assets that are outside of the reach of creditors in the event the employer is liquidated. That, however, does not mean that the retirees' health benefits may not still be tied to the employer's fortunes.[129]

Frequently, VEBAs are funded, in part, with employer stock or debt. For example, Dana Corporation agreed to contribute $700 million in cash and $80 million in common stock of the reorganized company to a VEBA in exchange for transferring a $1.1 billion liability to the VEBA.[130] Goodyear Corporation agreed to contribute $1 billion in exchange for transferring a $1.2 billion liability, and reserved the right to make up to $300 million of the contribution in company stock.[131] Of the $31.9 billion VEBA contribution GM has agreed to make, $4.4 billion will consist of a convertible note.[132] Of the $13.5 billion VEBA contribution Ford has agreed to make, $3.3 billion

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[124] Bernstein, *supra* note 3, at 13.

[125] O'Brien, *supra* note 2, at 2.

[126] Maureen Minehan, *Health Care: Lower Costs, But Still a Headache*, 24 Emp. Alert 2 (Nov. 15, 2007).

[127] Id.

[128] 2008 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds 7.

[129] Indeed, one recently established VEBA is entirely tied to the company's future with funding provided solely by a percentage of operating cash flow per ton of steel shipped. *See* Bernstein, *supra* note 3, at 9-10 (describing unusual VEBA agreement Wilbur T. Ross reached with workers from LTV, Bethlehem Steel, Acme Metals Incorporated, and Georgetown Steel).

[130] O'Brien, *supra* note 2, at 4.

[131] Id.

[132] Id. at Tables 1 & 2, at 7 & 8.

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will consist of a convertible note.[133] And, of the $56.5 billion Chrysler has promised to contribute, $1.2 billion will consist of a debenture.[134]

The value of these contributions are tied to the fortunes of the company.[135] To illustrate, when "Wheeling-Pittsburgh's share value declined by 27 percent in one week, the retirees of Wheeling-Pittsburgh took a big hit since their retiree medical benefit VEBA holds about four million shares of Wheeling-Pittsburgh stock. . . . That share-value reduction translated into a $13 million loss in value for the Wheeling-Pittsburgh VEBA, and there has been a $139 million drop in value for the VEBA when measured from the stock's all-time high following the creation of the VEBA."[136] If any of the companies in which a VEBA holds an interest is liquidated, the company stock will be worthless or nearly worthless, and the notes will rank as unsecured and unsubordinated debt might easily be worthless or nearly worthless as well.[137]

The new retiree health VEBAs may also be funded over time. For example, in the case of the GM VEBA, GM retains the right to make up to $7 billion of its potential cash contributions to the VEBA over a 12- to 20-year period.[138] If GM declares bankruptcy, there is no guarantee that that cash will be available or that GM will pay it to the VEBA.[139] Indeed, when Copperweld Steel was purchased in 1995, the new owners agreed to contribute $1.4 million each year to a VEBA to fund retiree health and life insurance. Six years later, however, when the new owner declared bankruptcy under Chapter 7, the company stopped paying into the VEBA when the court released it from its financial responsibility for the retiree program.[140]

Thus, the new retiree health VEBAs may protect retirees from the risk of their retiree health benefits being entirely eliminated in the event of bankruptcy. Nevertheless, they do not necessarily insulate retiree benefits from the fortunes of the company.

[3] The New VEBAs are not a Realistic Alternative for Many Employers

Although the new VEBAs have received a great deal of attention as of late, they are not likely to sweep the nation. The new VEBAs simply are not an appropriate funding vehicle for many employers.

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[133] Id.

[134] Id.

[135] *See* Stephen Diamond, *Legal Implications of Proposed GM/UAW VEBA*, Santa Clara University Research Note, 2-4 (Oct. 23, 2007) (explaining how GM's convertible note tied to GM's fortunes); Bernstein, *supra* note 3, at 15-16 (same)

[136] Keating, *supra* note 66, at 455.

[137] Bernstein, *supra* note 3, at 15.

[138] O'Brien, *supra* note 2, at 10.

[139] Id. at 10.

[140] Id. at 10.

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First, the new VEBAs are not a realistic alternative for pre-funding retiree health benefits for private sector employers' non-union employees. As discussed in section 7.03[3] above, IRC sections 419 and 419A limit private sector employers' ability to deduct contributions to pre-fund retiree health benefits for non-union employees. In addition, IRC section 512 generally imposes a tax on private sector employers' VEBAs' investment income and assets to the extent that contributions exceed the IRC section 419 and 419A deduction limitations. Thus, private sector employers are limited in their ability to use the new VEBAs as tax-favored vehicles for pre-funding retiree health benefits for non-union employees and should consider alternative methods for pre-funding retiree health benefits.[141]

Second, the new VEBAs are most appropriate for financially distressed companies with significant retiree health liabilities.[142] As discussed in section 7.05[1] above, the most significant advantage of the new VEBA to the employer is that it permits the employer to transfer its liability for retiree health benefits to the new VEBA, and in many, if not all instances, the employer may transfer significantly less money (and other assets) to the VEBA than the present value of its current obligation. Transferring the liability at a discount, particularly if the liability is significant, may improve the employer's credit rating and make future borrowing both cheaper and easier.

As discussed in section 7.05[2][b] above, historically most of the new VEBAs were formed during Chapter 11 proceedings, or more recently, have arisen when employers have threatened bankruptcy in collective bargaining negotiations. When employers are financially distressed, employees and retirees have an incentive to accept the transfer of liability at a discount. Any assets that are transferred may be outside the reach of the employer's creditors if the employer is liquidated.

If there is no realistic risk of liquidation, the employees and retirees have less incentive to accept the transfer of liability at a steep discount. And there is much less benefit to the employer if the transfer of liability is not made at a significant discount. Indeed, financially viable companies are likely to find that they can get a better return by investing their assets in their own business than by transferring their assets to a VEBA.

Thus, the new VEBAs are clearly advantageous to some, but not all, employers.

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[141] See authorities cited in note 26, *supra,* for a discussion of alternative means of pre-funding retiree health benefits.

[142] Businesses turn to VEBAs to spruce up balance sheets, offload risks; Automakers fund tax-free trusts for retiree medical benefits. But can unions manage health care plans better than employers?, Financial Week (Jan. 22, 2008) ("Derek Guyton, a principal with Mercer, said financially distressed organizations with large union populations, such as manufacturing, utility and airline entities, are the most likely candidates to turn to VEBAs to transfer their retiree medical obligations.").

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§ 7.06 CONCLUSION

Although the new retiree health VEBAs have received a considerable amount of press in recent months, they are not a panacea for this country's health care financing woes. The new VEBAs are an appropriate vehicle for pre-funding retiree health benefits for some employers, particularly financially distressed employers with significant retiree health care liabilities and large union workforces. For employees and retirees in these organizations, the new VEBAs may provide workers and retirees with some assurance that their retiree health benefits will not be immediately entirely eliminated. The new VEBAs can not, however, guarantee employees and retirees that retiree health benefits will never be reduced and eliminated. Nor can the retiree health VEBAs in and of themselves reign in this country's spiraling health care costs. They are simply a vehicle for pre-funding retiree health benefits that may be appropriate for some employers to consider.