

Reorienting Retirement Risk Management

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Chapter 13

Can VEBAs Alleviate Retiree Health-Care Problems?

Aaron Bernstein

Recent negotiations between the United Auto Workers (UAW) and Detroit automakers have focused attention on a potentially innovative response to the costly problem of retiree health insurance. To alleviate the companies' chronic losses, the union agreed to establish Voluntary Employees' Beneficiary Associations (VEBAs) at General Motors (GM) Corporation, Ford Motor Corporation, and Chrysler Corporation. These nonprofit trusts, which are run by an independent board of trustees, were set up to assume responsibility for UAW retirees' medical care starting in 2010, allowing the three companies to remove a total of more than \$100 billion in long-term liability from their books (Maynard and Chapman 2007). When the trusts are up and running, 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. As medical inflation increases 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 saving.

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 first portion of this chapter describes the general history of VEBAs and why they have surfaced as an issue at unionized companies. Next, we examine the advent of stand-alone employee VEBA like those under construction in the auto industry. We then focus on the bargaining trade-offs made by GM and the UAW as they negotiated the new employee VEBA, and how the agreement they reached in 2007 stood up when GM went through a bankruptcy reorganization in 2009. Finally, we

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look at VEBAs in the larger context of declining retiree health coverage in the United States and discuss ways in which the idea could address the issue for both union and nonunion employees. We also examine how employee VEBAs may apply in the public sector, where many employers face legacy costs as burdensome as those in the auto and steel industries.

Why VEBAs came to the fore

A VEBA is a tax-exempt trust as defined under Section 501(c) (9) of the Internal Revenue Code. Its 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 (Richardson and Salemi 2007). 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 restricts their usefulness for most of the US workforce. But for those who qualify, they offer one of the best tax breaks available. If set up properly, contributions by employers and employees alike are not taxed going in, any earnings the trust makes over the years are not taxed, and the money withdrawn to cover a retiree's medical care is not taxed either (Richardson and Salemi 2007). This surpasses the tax benefits available through conventional retirement plans 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' that functions more like a traditional defined benefit (DB) 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 (DC) such as a lump sum, yet pays the premiums of a traditional health plan. 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 onetime basis when the employee retires (Richardson and Salemi 2007).

Most of the 11,996 VEBAs in existence as of 2008 were set up by employers as tax-advantaged funding schemes (IRS 2008). A VEBA board selects

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professional investment managers and investment vehicles and decides on distribution options and levels (NCPERS 2006). The new VEBAs at the auto companies will be run independently of the companies. 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 twentieth 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 (McGuinness 2007). 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 (Schultz and Francis 2007).

Nevertheless, VEBAs at unionized employers remained exempt from the restrictions, so workers there can make tax-free contributions and receive tax-free benefits from the VEBA (Employee Benefit Research Institute 2005). As a result, these 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 (Schultz and Francis 2007). Typically, employers use them to pre-fund their long-term retiree health obligations. VEBAs also are used for this purpose by multiemployer health and welfare plans, which usually involve a union that has set up a plan covering members at multiple companies.

VEBAs are attractive to companies for another reason as well. Just like a corporate pension fund, any extra returns earned by the company-sponsored plan are included in a company's bottom line (assuming the plan is a traditional one and not the newer stand-alone variety such as in the auto industry). For example, Procter & Gamble Company's VEBA added more than \$600 million to the company's earnings in 2005 and 2006 (Schultz and Francis 2007). 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 (Figure 13.1).

While few employer surveys shed light on the reasons for this growth, it likely stemmed, in part, from companies' desires to save funds to defray the mounting costs of an aging workforce, especially in mature unionized industries. Retirees also were living longer, further ratcheting up a long-term obligation that employers could use VEBAs to fund. It was this

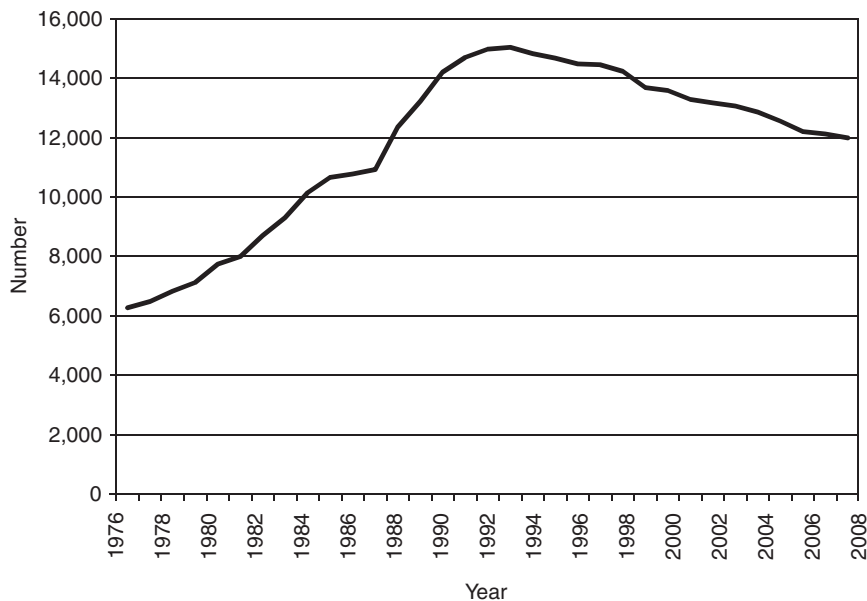
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Figure 13.1 Number of Voluntary Employees' Beneficiary Associations (VEBAs) in the United States, 1976–2008. *Source:* Author's calculations using IRS (various years).

swelling long-term liability that eventually led employers to the idea of using VEBAs to transfer retiree health responsibility to union members.

This notion stems back to a 1990 regulatory action that for the first time required employers to record retiree health obligations as a corporate obligation. 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' financing. But that year, the Financial Accounting Standards Board, which provides guidelines for the financial reports of public corporations, issued Financial Accounting Statement (FAS) No. 106 (Fronstin 2005). Starting in late 1992, FAS 106 required companies to use what is called an 'actuarial accounting method,' which requires them to record a liability on their books for the total cost of all 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 active workers.

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. But the

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FAS move had a profound impact on employer-paid retiree health benefit offerings. 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 among large employers which had always been more likely to offer retiree coverage than smaller ones (Fronstin 2005).

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 a onetime charge against their earnings. Other chose to stretch out the cost over many years (Employee Benefit Research Institute 2005); a few were even forced into bankruptcy (Richardson and Salemi 2007). 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 percent of companies with 500 or more employees in 1993 but only 28 percent in 2004 (Fronstin 2005). Since then, the number of VEBAs has drifted downward as well, to 11,996 in 2008 (IRS 2008).

Some private firms that elected to continue paying for retiree health benefits decided to use VEBAs to pre-fund the obligations, as did some public-sector employers (Employee Benefit Research Institute 2005). GM itself had set up an internal VEBA years ago, long before it asked the UAW to take over responsibility for retiree coverage. By the time the 2007 round of bargaining began, GM had put away \$16 billion into this preexisting VEBA (GM Corporation 2007*b*).

Stand-alone employee VEBAs

The new employee VEBAs used by the three auto companies to shed legacy costs have taken a different form from the traditional VEBA. These new ones are DC trusts, into which the company puts a specified set of assets to be used to cover all future benefits. Unlike a traditional pension or a DB VEBA, a stand-alone VEBA carries no guarantee by the employer of a certain level of benefits, leaving employees to bear the risk that the assets will not keep pace with future medical inflation.

A tax lawyer's phrase for what the auto companies have sought to do 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 is not a legal obligation at all. From management's perspective, the cost being shifted is one that many companies voluntarily took upon themselves and therefore represents a decision they are free to reverse at any time.

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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 do not 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 depends on the specific facts of what it told employees over the years (Macey and O'Donnell 2003). The issue has been litigated at many companies, with labor prevailing in some instances and management in others. The outcome usually depends on whether employer statements and other actions can be construed as an explicit or implied promise to continue health coverage throughout employees' retirement (Macey and O'Donnell 2003).

While this legal uncertainty can make it difficult for employers to shed retiree health coverage for unionized workers, it is far easier to do so 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 (USW) retirees and their dependents lost coverage as their companies either restructured their debts or simply went out of business (USW 2003).

As a result, most defeasance VEBAs have been set up at companies that have either entered bankruptcy or faced the prospect of doing so (Ghilarducci 2008). 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 it promised to pay more in subsequent years. This trust continues to cover retirees, whose benefits have increased although co-pays have risen somewhat (Welch and Byrnes 2007). Other experiences have not fared as well, such as a VEBA the UAW agreed to at Detroit Diesel Corporation that has already run out of cash (O'Conner 2007).

One of the most innovative uses of a VEBA involved an effort by the USW union 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 are typically part of a larger set of bargaining trade-offs unions and employers make to balance the interests of the employer as well as active and retired workers. In 2001, LTV went into bankruptcy and began selling its assets; most of its workforce was laid off, and retirees lost their health insurance.

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To save what it could, the USW began negotiating with investor Wilbur L. Ross who sought 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 (ISG) Incorporated 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 Pension Benefit Guaranty Corporation (PBGC), which guarantees a portion of employee pension payments in case of bankruptcies. They had no similar recourse for health coverage, which is not protected by the PBGC (Arndt 2003; Byrnes 2003). 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 name was changed to ArcelorMittal USA).

Although the union's priority was to save as many jobs as possible, it also negotiated an unusual VEBA with Ross that, as of 2009, provided 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 could not afford to make any hard commitments to retiree health benefits. Instead, it set up a VEBA that is funded by a percentage of operating cash flow per ton of steel shipped (USW 2002). 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 co-pay of \$10 a month (USW 2006). 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 (Mittal Steel USA 2006). The trust earned enough to repeat the benefit in 2007 (USW 2007a).

While such benefits are better than nothing, they are a far cry from full coverage. The trust has not 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 Arcelor-Mittal retirees will fluctuate with the company's fortunes (USW 2007b).

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 would have otherwise lost all

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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 that 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 would be likely to cover future medical inflation. For unions, the key issue is ensuring that the trust will be funded as fully as possible. During the 2007 negotiations, GM and the UAW devised a package of creative financing options that allowed them to reach a middle ground on this central question.

This carefully crafted arrangement came undone in 2009 after the global economic crisis led GM and Chrysler (although not Ford) to seek assistance from the US government (Bunkley 2009). As part of that process, the government asked the companies to substitute company stock for up to half of the cash contributions the firms had agreed to make to the VEBAs set up in 2007 (GM Corporation 2009*a*, 2009*b*). Subsequently, both GM and Chrysler declared bankruptcy. Chrysler emerged in June through a complex deal that split ownership in the new company in three ways. First, the US government received an 8 percent stake in exchange for its \$9 billion in loans; second, Fiat got a 20 percent share for providing Chrysler with small-car designs and engines it can build and sell in the United States; and third, the VEBA received 55 percent (Linebaugh 2009). Despite the VEBA's majority share, the UAW agreed that Fiat and the government could name all of Chrysler's new board of directors except one, which the union chose itself. The following month GM also emerged from bankruptcy via a similar restructuring deal. The new company's ownership was split four ways, with the US government getting 60.8 percent, the VEBA receiving 17.5 percent, the Canadian and Ontario governments, which contributed bailout funds, getting 11.7 percent, and the old GM keeping 10 percent (GM Corporation 2009*a*).

The substitution of stock for cash contributions from the companies drastically altered the 2007 contract regarding the VEBAs, placing substantially more risk onto UAW members and retirees. Still, the existence of the VEBA gave the union a much stronger hand to play when GM and Chrysler declared bankruptcy. The companies had entered into legal obligations with the VEBA trusts that were more difficult for them to abrogate than might have been the case if they had only had the prior disputed obligations to cover retiree health costs. As tangible legal entities, the VEBAs gave the union a powerful bargaining tool that allowed them to extract equity on an equal footing with the US and Canadian governments and Fiat, ahead of GM and Chrysler bondholders. Without this privileged position, it is possible that UAW retirees could have lost more or even all of the retiree health benefits they had fought for over the years.

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The intricate compromises the companies and the union reached when they agreed to the VEBAs in 2007 shed light on the relatively powerful bargaining position the UAW enjoyed when bankruptcy hit. The middle ground they found then also covered a range of sensitive issues that others would face in a similar process, including how much of the funding expense would 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. Its flexibility in the face of the auto industry's near-collapse a year later is instructive as well. Not every union or employer would want or be able to emulate every tactic, but any that pursue a defeasance VEBA would be well served to learn from the UAW's experience at GM.

The GM VEBA created in 2007 came about in very different circumstances from those at ArcelorMittal. It represents the culmination of a 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 percent of the US market 20 years ago to just 25.5 percent in 2007 largely because of its inability to design vehicles that were more appealing than those offered by Japanese rivals (Sixth Circuit Court of Appeals 2007). 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.

Whatever the cause, GM, Ford, and Chrysler all still bore the burden of the enormous sums they expend on legacy costs. GM has frequently pointed out in recent years 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. The \$5.4 billion GM spent on health care in 2005, more than two-thirds for retirees, added \$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 (Sixth Circuit Court of Appeals 2007).

GM first prevailed on the UAW to reduce retiree health cost in 2005. In an unusual mid-contract concession, the union agreed to changes including higher co-pays and deductibles that cut \$17 billion off the company's \$67.6 billion retiree health-care obligation (Sixth Circuit Court of Appeals 2007). 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 DC 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 (GM Corporation 2007a). This

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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 was 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 effect in 2010.

An analysis of why the UAW agreed to this extraordinary move sheds light on its subsequent 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 (Sixth Circuit Court of Appeals 2007). To address the problem, management closed or idled factories, laid off 37,000 employees, and cut executive salaries and dividends to shareholders. It also demanded that the UAW agree to steep reductions in retiree health benefits. When the union refused, GM threatened to impose them unilaterally, leaving 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.

A 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 Sixth 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' (Sixth Circuit Court of Appeals 2007). 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

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immediate cuts on top of the ones they suffered after the 2005 concessions). It also split the risks the VEBA would 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 thought at the time that it could afford, even its distressed circumstances.

The middle ground the parties reached in 2007 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 percent as a long-term average for US health-care cost increases (GM Corporation 2007*a*).

At first blush, this seems wildly optimistic given the double-digit increases of recent years. Yet many experts use something in that ballpark for long-term projections, on the assumption that the current pace is simply unsustainable over many decades.¹ 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. Those risks will heighten drastically if GM follows Ford's lead in 2009 and substitutes stock for half of the funding it had agreed to in 2007.

The 5 percent medical inflation assumption resulted in a present-value estimate of GM's long-term retiree health obligation that totaled roughly \$47 billion in 2007 (GM Corporation 2007*a*). This figure represented the cost as of that time 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 (GM Corporation 2007*a*).

The UAW also agreed to a relatively generous figure for the second critical financial assumption, about projected returns. Just as the 5 percent 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 percent,

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TABLE 13.1 Funding for the General Motors (GM) 2007 Voluntary Employee Benefit Association (VEBA)

Source	Amount (\$ billions)
<i>Panel 1: From GM</i>	
Transfer from existing VEBA	16.0
Cost of paying retiree health until VEBA starts in 2010	5.4
Convertible note	4.37
Backstop payments	1.74
Excess pension funds	1.7
2005 payment due in 2011	1.0
Subtotal	30.21
<i>Panel 2: From the United Auto Workers</i>	
Diverted 2005 wage hikes and cost of living adjustments	5.6
Diverted 2007 wage hikes and cost of living adjustments	2.5
Subtotal	8.1
Total	38.31

Source: Author's calculations derived from General Motors Corporation (2007a, 2007b).

even though GM said it would employ a much more pessimistic 6 percent on its own books.² 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.³

This 9 percent rate of return was probably a reasonable assumption for both sides (perhaps even after the market crash that began in the fall of 2008). While GM's own accounting assumption of 6 percent suggested that it may be optimistic, the rate is actually a bit less than the 10 percent 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 (or it seemed so prior to the 2008 market crash). However, it did mean that the trust lacked a large cushion to buffer the inevitable fluctuations in returns, much less a full-scale collapse such as occurred in 2008. If returns slump for many years, trust officials may be forced to reduce benefits at least temporarily, until the stock markets recover.

The two sides reached another series of intricate compromises in 2007 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 agreed to make were given in exchange for job, wage, and work-rule concessions. Still, GM agreed to

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put up slightly more than \$30 billion of the total directly, while UAW workers agreed to pay for the remaining \$8 billion by diverting future pay hikes into the VEBA. Next, we offer more detail on each party's contributions (see also Table 13.1).

Sources of GM's Contribution

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. Much of the rest of GM's contribution came from financial moves that also will not 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 DB 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.)

The UAW accepted another \$4.3725 billion in the form of a note convertible to GM stock. After the note was issued in January 2008, it will require GM to make semiannual interest payments to the trust. Six months before the note matures in 5 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 is not a straight stock grant, it is also 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 unsecured 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 cannot 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 cannot sell more than 2 percent 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 percent

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of GM's outstanding stock – will link the UAW to GM in a new way. A recent Citigroup 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' (Michaeli, Randow, and Reenock 2007).

To allay UAW concerns that the trust might not earn enough to cover future costs, GM has also agreed to make \$1.74 billion in twenty 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 further agreed to make 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. Nevertheless, even before the 2008 market crash threw out all of the 2007 cost projections, it was likely that the company would have been required to make most or all of the payments, since they were included in the union's analysis that \$38 billion would fully fund current retiree health benefits over the long term (UAW 2007).

Another \$1.7 billion came from what appeared 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 (Sloan 2005). By 2007, the pension was overfunded by \$17 billion (Michaeli, Randow, and Reenock 2007), but under federal pension rules the overfunding was insufficient 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 (GM Corporation 2007b). The pension pass-through, as it is called, was expected to generate \$1.7 billion for the VEBA (in present-value terms) at no cost to retirees.

A last part of the funding from GM came from the final \$1 billion payment due in 2011 that GM had promised during the 2005 mid-contract cutbacks, which the parties agreed to count toward the new VEBA.

Sources of UAW's Contributions

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.⁴ During negotiations over the new VEBA in 2007, the UAW agreed to redirect

additional wage and COLA increases it had negotiated, which added another \$2.5 billion.

These complex series of compromises made sense in 2007, before the global recession hit in 2008. By the time the UAW agreed to accept stock for up to half of what Ford had agreed to put up for the VEBA it had agreed to in 2007, GM was essentially bankrupt and on life support from the US government (Bunkley 2009). At this point, the UAW faced a calculation similar to the one it made in 2007, although a more drastic one. It could agree to take more stock to fund the VEBAs at the three companies, dramatically increasing the likelihood that retirees would face steep benefit cuts should the companies recover slowly, as seemed probable. Or it could refuse and risk a bankruptcy filing that would very likely end all retiree health coverage.

One of the few positive conclusions about the events of 2009 is that they illustrated the remarkably flexible nature of VEBAs. At all three auto companies, UAW retirees now face a much greater risk that they would not receive the health coverage anticipated when the VEBA was agreed on in 2007. Yet they do still have a trust fund, and if the economy and the company recover, it is possible that they could enjoy everything agreed on back then. GM's situation was more dire than Ford's in 2009, as was Chrysler's, but the VEBA structure gives retirees there at least the possibility of future coverage. Without it, they almost certainly would be left with nothing after the companies' near collapse.

Furthermore, it is entirely possible that the companies may not have freed themselves of their retiree obligations despite the elaborate effort represented by the defeasance VEBAs. For example, the agreement the UAW and GM reached in 2007 stated 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. (GM Corporation 2007*b*)

Presumably, such explicit language is sufficient to convince the Securities and Exchange Commission that GM no longer will bear responsibility for UAW retiree medical coverage and therefore can wipe the billions in FAS 106 debt off its books.

It should also be noted that, directly following the earlier language, was a second sentence which said: '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' (GM Corporation 2007*b*). This second

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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 was designed to do, there appears to be little 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 have changed 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 is 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. The company's legal theory was never tested by the courts, and it is entirely possible that the union would have prevailed in its view that retiree health benefits were 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 such as those set up in Detroit present a mixed set of problems for unions. They do offer several advantages over employer-provided insurance, most significantly, they put workers in the driver's seat. The GM model 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 (UAW 2008). 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 can offer a fair degree of insulation from employer bankruptcy, depending on how well funded they are and how much employer stock they hold. But 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. When employers pay for retiree health benefits, they bear the cost of future medical inflation. With a stand-alone VEBA, workers and retirees do. If trust assets fail to earn enough to keep pace, as seemed highly likely with the automakers in early 2009, 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 can 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. But even prosperous unionized companies may seek VEBAs that sever their retiree health obligations at a discount.

In sum, however, 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. Similarly, a VEBA half funded by stock in threatened companies is highly risky, but perhaps better than nothing at all.

Discussion

Experts have long suggested that the VEBA concept could also help other employers and employees better manage the mounting cost of retiree health insurance (Macey and O'Donnell 2003; Richardson and Salemi 2007). For instance, 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 (Miller 2007). But given the different political dynamics of government employment, defeasance could be even more difficult for them to achieve than it has been for corporations. Public-sector legacy-cost pressure is strikingly similar to that in the private sector, though many public employers have focused on the issue only recently. Some estimates peg the total unfunded public-sector liability for retiree health benefits at close to \$1 trillion (Miller 2007). 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 (Segal Bulletin 2004). Some have already set up internal VEBAs or other pre-funding schemes to cope with the newly visible liability.⁵ 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 (Wisniewski and Wisniewski 2004). All those not pre-funding, including counties, municipalities, and other local entities, now must struggle with how to respond to the new accounting rules.

Though the cost burden on some public employers may be just as crushing as it is on some private ones, the response is different. To begin with, public entities do not pay taxes, so there is 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 corporations do not

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face. The beneficiaries usually are voters, which gives them opportunities to object to such efforts that private-sector workers do not 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 a public entity did curtail retiree health-care coverage, leaving some retirees unable to cover medical expenses, the public sector could find itself picking up some of the tab anyway. Such concerns could make it difficult to emulate the automakers 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 cannot sever the liability through a defeasance approach. 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 saving. 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 cover more of the cost. Eventually, pre-funding even could lead to lower yearly outlays (Wisniewski and Wisniewski 2004).

In addition, pre-funding allows public entities to post a lower liability on their books. It does not 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 (Segal Bulletin 2005). By contrast, 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 measured obligation, just as GM was able to do by using a 9 percent return assumption with the UAW instead of the 6 percent it used with Wall Street. The rationale is that money not in a trust is not 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 that pre-funding requires. Such investments can be extremely expensive, up to 10 times as much as what is required on a pay-as-you-go basis (Segal Public Sector Letter 2007*a*). Public entities spend their annual budgets on education, police, or other services. Pre-funding retiree health benefits requires them to divert scarce resources from these other needs, often essential ones, which many may be reluctant to do. Similarly, many governments have other long-term obligations to fund such as bonds floated to build roads or schools, and they may not want to sink resources into retiree health coverage instead. In addition, the funds put in a VEBA trust cannot be tapped should a budget deficit or other fiscal crisis hit in the future.

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VEBA pre-funding also raises difficult issues of intergenerational equity among 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 are also usually shifting costs for workers serving them today onto tomorrow's taxpayers. No generation necessarily comes out ahead or behind, since the cost each bears depends on medical inflation and the relative level of service provided in each era (Wisniewski and Wisniewski 2004). 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 is 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; see Macey and O'Donnell 2003). 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 is 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 has not been tested, and it is 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 non-union workers, independent employee trusts are more difficult to set up for the majority of the workforce that today lacks retiree coverage (Fronstin 2005). While nonunion employers can make contributions to a VEBA if they wish, there are strict limits on the amounts (Macey 2007), 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 few nonunion employer-pay-all VEBAs tend to have few participants (Macey and O'Donnell 2003). Conceivably, nonunion employers also could use a 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 plan. The IRS requires fully deductible VEBA contributions to be mandatory, so that employees cannot choose between cash and the contribution. Typically, this is done through a union, which bargains rules that apply to all members (McGuinness 2007; Richardson and Salemi 2007).

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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 rules that allow 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 has not 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. Currently, the only tools available are DB pensions and DC plans like 401(k)s. But the money that workers withdraw in retirement from such plans is taxed, even if spent on health care. There is nothing in federal tax law today like an employer medical plan or a Flexible Savings Account, which retirees can use to purchase health care on a pretax 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 pretax 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.

Conclusion

The larger problem with any VEBA-like remedy for falling retiree health coverage is that it would do little to address the central issue facing both retired and active workers, which is the ever-increasing cost and lack of affordable health-care coverage. Already, many Americans are uninsured or underinsured because they can not afford the premiums, co-pays, and deductibles. Giving them a new tax-free saving plan may be better than nothing, but it would likely not 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.

Congress and the White House were engaged in serious debates about just such a solution throughout the first year of the new Obama Administration. Prospects for national health-care reform remain uncertain, the passage of such legislation could mean that stand-alone VEBAs would turn out to be a real windfall for UAW members, depending on how the law is written. If a new system provided workers with access to affordable care,

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UAW members and others with extra funds saved in a VEBA could be much better off. The stock and other funds contributed by the automakers cannot be removed after they are put in to VEBA trusts, which means that union participants could 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 would not run out of money. While the UAW did not agree to VEBAs with this goal in mind, the union has been actively backing reform proposals, in which case employee VEBAs could turn out to be an unexpected cushion for its members.

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Notes

- ¹ For example, Medicare projects national health-care expenditures over a 75-year time horizon. In recent years, they have exceeded the gross domestic product (GDP) of the United States by several percentage points a year. However, Medicare's standard assumption is that over the next 75 years, expenditures will gradually decline to a long-term growth rate of 1 percentage point over GDP, which put health-care spending increases in the range of 5 percent a year. 'The theory behind this model is that, should medical technology continue to increase rapidly, and expensively, in the future, then eventually society would be unwilling and unable to devote a steadily increasing share of its income to obtaining better health' (Board of Trustees 2008: 168).
- ² A by-product of this decision was that GM will be able to treat the difference between these two figures as a profit. In 2007, the company estimated that its annual earnings would increase by \$2.6 billion to \$3.6 billion starting in 2010 as a result of the two different rate-of-return assumptions (although the figure could decline somewhat in subsequent years).
- ³ The \$38 billion would come close to \$47 billion under a 6 percent discount rate, according to the UAW (GM Corporation 2007a, 2007b).
- ⁴ The dollar value of these contributions may change because they are based on hours worked, which will fall below projections as GM continues to downsize.
- ⁵ In addition to VEBAs, public employers also can use Internal Revenue Code Section 401(h) accounts or Section 115 trusts to pre-fund post-employment benefits such as retiree health care. Most that already have pre-funded have

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used 115 trusts, although that may change now that Goodyear and the auto-makers brought visibility to VEBAs, which allows them to set up trusts for essential purposes (Segal Public Sector Letter 2007*b*).

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