

FUNDING RETIREE HEALTHCARE LIABILITIES

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Years ago, many publicly traded companies agreed to provide their retirees healthcare benefits. This facilitated labor relations and was widely considered socially beneficial. However, in recent years, rising medical costs, longer life spans and global competition have rendered these benefit obligations increasingly challenging for employers to maintain. In the meantime, the Financial Accounting Standards Board recently adopted accounting and disclosure rules that require companies to report the funded status of retiree health plans on their balance sheets. As a result, companies that previously were not particularly motivated to fund those obligations now are more in-

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clined to do so and, at the very least, are seriously concerned about the impact of underfunding on their financial statements.

Among the many public companies struggling to fund retiree healthcare liabilities, some have used or proposed company stock as a plan asset. Establishing a trust to provide retiree health benefits and contributing company stock in lieu of or in addition to cash may be attractive in many situations, providing a helpful approach for financially stable companies as well as those in financial distress, for companies that intend to continue providing health benefits to retirees as well as those that may reduce or restructure them through bankruptcy proceedings, collective bargaining, or unilateral action. While an in kind contribution of stock to a retiree healthcare trust may prove an effective way to help fund these obligations—and in notable cases already has—it also can be complex, time consuming and full of challenges, especially when part of a bankruptcy reorganization.

BACKGROUND

“... the light at the end of the [retiree healthcare] tunnel is another train, and it is heading straight for us.” (S&P report, June 2006)

Some large publicly traded companies have nearly fully funded their defined benefit pension plans, and the recent federal Pension Protection Act will force the rest to move more quickly in that direction. However, most public companies with *retiree healthcare 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). Concentrated in unionized companies, these liabilities are characterized as “enormous” and an “onerous burden” by Bill Gross of fixed-income giant, PIMCO, with specific reference to General Motors.

Roughly two-thirds of the companies in the Standard & Poor’s index of 500 stocks—and over half of companies employing more than 5,000 people—still offer retiree health benefits, according to a 2006 report in the Wall

Street Journal. Yet, as a group, companies in the S&P 500 have funded only about 22% of the cost of their retiree health benefits, compared to 90% funding for pensions, according to the 2006 report from S&P. The underfunding of retiree health obligations among manufacturers, utilities, and telecomm companies is particularly dire, according to that S&P report.

A recently issued statement from the Financial Accounting Standards Board (FASB) will likely make the problem increasingly visible and thus a problem that management and labor must address. (S&P called it a “wake-up call to investors, financial planners and politicians.”) Through its Financial Accounting Standard 158, FASB will require disclosure in the balance sheets of corporate financial statements (not merely in the footnotes, as previously permitted) of the liabilities associated with “other post-employment benefits” (OPEB) such as retiree medical obligations. Although ERISA doesn’t require pre-funding of retiree medical liabilities as it does defined benefit pension liabilities, the FASB requirement will likely force corporate America to address more squarely its accrued obligations to pay future retiree healthcare costs. This is especially true because companies cannot dump retiree healthcare obligations on the federal government and taxpayers the way they can dump pension obligations: there is no medical equivalent to the federal pension insurance agency, the Pension Benefit Guaranty Corporation. Furthermore, collective bargaining agreements may contractually restrain companies from unilaterally reducing or eliminating their obligation to maintain previously promised healthcare

benefits. On the other hand, ERISA does not statutorily bar reducing or eliminating accrued retiree health benefits the way it does pension benefits, thereby making it easier for companies to trim the former, especially (but not only) through bankruptcy proceedings.

The projected impact of moving OPEB liabilities onto the balance sheet is substantial. In June 2006 S&P projected that the move would reduce common tangible book value in the S&P 500 by some 8 to 9%. S&P expects that the “FASB project will have a significant impact on stock evaluations, income statements and balance sheets, and will become the major issue in financial accounting, over the next five years.” This is a situation that management, labor and shareholders cannot afford to ignore. Putting it more dramatically, S&P “expect[s] this issue to rise to national attention and engulf both financial and social policy.”

To the extent companies have not yet pre-funded these obligations, how will they pay for them? Some companies—both stable and distressed—have begun limiting future promises (Nissan and GM announced caps going forward), thereby shifting costs to their workforce. Nevertheless, for the many companies with enormous obligations already incurred, those steps alone do not begin to solve the problem. Accrued obligations must be paid, unless eliminated or reduced through bankruptcy proceedings or legal arguments that the benefits were not binding contractual promises and thus may be unilaterally abrogated.

IN KIND CONTRIBUTIONS

Given the enormity of their retiree health obligations, increasing numbers of companies may seek to

pre-fund those obligations partly through in kind contributions in lieu of—or in addition to—cash contributions to a separate legal entity organized as a trust to fund these benefits.

In concept, this approach is not novel. Over the years, many companies have funded at least some of their pension or health obligations through contributions of employer stock or employer real estate in lieu of cash. Some of these transactions have involved contributions necessary to meet statutory minimum funding requirements of defined benefit pension plans, while others involved voluntary excess contributions (to fund either pension or health benefits); some have involved relatively sound companies while others involved companies in financial distress, including bankruptcy. Examples of in kind stock contributions include General Motors (pension obligations), US West (retiree health), Kinder Morgan (retiree health), and—announced at the very end of 2006—Goodyear Tire & Rubber Company (retiree health).

Paying an in kind contribution rather than cash typically requires a prohibited transaction exemption from the U.S. Department of Labor, as further discussed below.

RESTRUCTURING LIABILITIES AND FUNDING WITH EMPLOYER STOCK

Over the past few years, public companies in the airline, steel and auto industries have sought to restructure their labor obligations. A key component includes renegotiating retiree health liabilities—either in the context of “regular” labor negotiations or through bankruptcy proceedings—and funding the liabilities at least partly with common stock of the employer.

Under this approach, the company and its union negotiate to establish a trust—commonly a “voluntary employees beneficiary association” (VEBA) under Section 501(c)(9) of the Internal Revenue Code¹—and agree to fund it fully or partially with a contribution of common stock. This may occur with companies in bankruptcy (as with Navistar International, Kaiser Aluminum, Tower Automotive, and Wheeling-Pittsburgh Steel), with companies fearing—but not yet in—bankruptcy (like automakers discussed below), and with solvent companies (such as Goodyear, which resolved a labor dispute with the right to fund retiree health obligations partly with company stock).

In the context of bankruptcy, the negotiations may occur pursuant to Section 1114 of the Bankruptcy Code,² and the contribution may be made in connection with the company’s emergence from Chapter 11. Once the deal is struck, the VEBA gains a right to receive the stock, assuming the company emerges from bankruptcy pursuant to a court-approved reorganization plan that provides for the VEBA’s funding. If a market develops for pre-emergence sales of bankruptcy claims, then creditors like the VEBA may be able to sell some or all of those rights to stock, converting them into cash even while the company remains in Chapter 11, as the Kaiser Aluminum Retiree Medical VEBA did in 2006. Once the company emerges, the VEBA should be in a position, over time, to liquidate its stock, using cash proceeds to pay current benefits and investing the balance in a more diversified, long-term investment program. Again, the Kaiser Retiree VEBA is a good exam-

ple, having raised, in early 2007, nearly \$200 million in proceeds through a successful secondary underwritten offering of employer stock that the company contributed in connection with its emergence from bankruptcy in July of 2006.

Another variation of this approach is what General Motors, Ford, and Chrysler are reportedly discussing with the United Auto-workers, building off of the example of Goodyear’s recent negotiations with the United Steelworkers. In this approach, the company seeks to shift responsibility to the union for retiree health care costs and provides an agreed-upon, maximum level of funding to a VEBA trust. From the company’s perspective, even assuming it provides billions in funding, this may establish an upper limit to its obligation (rather than leaving it open-ended) and furthermore may constitute less of a contribution than it would otherwise bear as the ongoing plan sponsor. Moreover, some of the funding may consist of employer stock in addition to cash. An advantage from the union’s perspective is that this approach may remove the trust from possible future bankruptcy reorganization procedures where the company may seek to renegotiate—read “reduce or eliminate”—healthcare benefits for retirees.

ADVANTAGES & CHALLENGES OF FUNDING WITH EMPLOYER STOCK

The advantages of using employer stock to help fund retiree health obligations—regardless of whether the employer is in bankruptcy or not—include:

- Continuing retiree health benefits for future retirees, rather than entirely scrapping them

- The possibility over time (as stock is sold and the proceeds are reinvested) of developing a diversified investment program to support retiree health benefits over the long term
- Reducing the immediate pressure on the company for cash contributions
- Partially or fully funding the obligation, which in turn may strengthen the corporate balance sheet and enhance the value of the stock
- Aligning the interests of workers (both retirees and current employees who are likely to gain coverage in the future) with the long-term interest of the company and other shareholders.

But utilizing employer stock in lieu of cash may also entail major complications and pitfalls. Many of these apply across the board (whether the company is financially stable or not), and others apply particularly to reorganizing companies. Among the complications are:

- Concentration of investment risk. Initially, at least, the VEBA’s viability is tied significantly to the fortunes of a single company.
- Regulatory obstacles. Under a variety of ERISA-prohibited transaction rules, contributing substantial amounts of employer stock to any benefit plan in lieu of cash may require exemptive relief from the Department of Labor. For example, if the percentage of stock of the newly issued company that the VEBA will own exceeds certain limits or fails certain tests of marketability, the stock will not be deemed a “quali-

fy employer security” under ERISA Section 407, and thus, the funding will require a prohibited transaction exemption from the U.S. Department of Labor. Fortunately, the DOL has granted several exemptions for such transactions in recent years.

- Need for an independent fiduciary. One ingredient for a successful application to the DOL is installing an “independent fiduciary” to act on behalf of the VEBA. VEBAs are typically structured as Taft-Hartley benefit funds with a joint labor management board of trustees, consisting of representatives from labor and management, or as corporate benefit funds with company officers or directors as fiduciaries. (As mentioned earlier, some companies have recently considered structuring a board consisting solely of labor representatives in connection with shifting responsibility to the union). In any event, the resulting board of trustees is typically deemed conflicted on decisions regarding accepting, managing, and selling company stock. The independent fiduciary is responsible for acting objectively and expertly on behalf of the VEBA, in lieu of the regular trustees, on at least two fronts: (i) initially determining whether to accept the in kind contribution of employer stock, (ii) thereafter managing and disposing of it for the VEBA and its participants and beneficiaries, including voting the VEBA’s proxies.
- Investment consulting. As cash is raised through sale of the stock, re-investing the

proceeds and managing the diversified investment portfolio may no longer entail a conflict of interest for the regular fiduciaries. However the board may still want an independent fiduciary with sufficient expertise as an investment consultant to advise them on how to develop and monitor a diversified portfolio suitable for paying benefits over time and becoming a self-sustaining trust fund.

- Restrictions on selling the stock. The contributed stock may not be freely tradable and liquid for one or more of several reasons, including, for instance:
 - Securities law limitations. If it owns enough company stock, the VEBA may be deemed an “affiliate” of the company under the ’34 Act and limited to sales under Rule 144, which permits only a “dribble out” of shares over time.
 - Unmarketability. Regardless of legal restrictions, if the company’s stock is thinly traded and/or the VEBA is a major shareholder, sales may require an extended time period because of limited liquidity. Blockage and constraints on liquidity may also warrant discounts on the value of the stock and thus on the value of the VEBA’s assets available for benefits.
 - Rules concerning net operating losses (NOLs). Many companies emerging from bankruptcy have NOLs that they may apply as a credit

against future taxable income. These NOLs can be among the reorganized company’s most valuable assets. However, sales of stock beyond certain percentage limits by long-time creditors of the company who receive stock through the reorganization (perhaps including the VEBA) may limit the rate of usage or even forfeit a significant portion of those NOLs. Thus, the stock contributed to the VEBA may be subject to restrictions on sale to preserve the value of the NOLs. The rules for this are complex, and the sales must be carefully controlled.

- Public sale of the stock. Even assuming the stock is restricted, the VEBA may retain rights to demand registration. If so, then the independent fiduciary may be in a position to arrange for an underwritten offering of the VEBA’s stock—which (if properly managed) should facilitate widespread sales at attractive prices.

In the face of these complications, an effective independent fiduciary may spell the difference between success and failure. For example, if the VEBA receives a pre-emergence interest in company stock, an astute independent fiduciary may be able to sell some or all of those interests at an attractive price in the pre-emergence claims trading market. In one breath, the independent fiduciary may reduce the VEBA’s investment risk from concentration in the stock, enhance the VEBA’s immediate liquidity (and thus, ability to pay benefits), and increase the prospect of gaining DOL approval for a prohibited transaction exemption. The ide-

al independent fiduciary for these types of transactions combines experience regarding employer securities in qualified plans with experience designing long-term diversified investment programs, regulatory expertise, and a successful history working with the Department of Labor on exemption applications.

CONCLUSION

In short, faced with large unfunded

retiree health liabilities, management and labor face daunting challenges. From labor's perspective, establishing a VEBA and partially funding it with employer stock may help sustain promised benefits. From management's perspective, such funding may improve the balance sheet, limit future obligations, help conserve cash, and maintain labor peace. While this type of arrangement is typically complex, given recent

trends—including FASB's latest pronouncements—look for both healthy and stressed companies with unionized workforces to increasingly establish VEBAs and fund them partially with employer stock.



NOTES

- 1 IRC § 501(c)(9).
- 2 11 U.S.C.A. § 1114.