Chapter 6

THE PENSION PROTECTION ACT, VEBAS, AND OTHER CHANGES TO THE PROVISION OF RETIREMENT BENEFITS: SHOW ME THE MONEY

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Panelists: Harry Burton, Morgan, Lewis & Brockius, Washington, DC
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The panel will review the changes in the manner that employers and unions provide retirement benefits that will likely result from the Pension Protection Act (PPA). The historic shift in the manner in which retiree health and other retirement benefits are provided through negotiation of Voluntary Employee Benefits Associations (VEBAs), as exemplified in the United Auto Workers (UAW)-Big Three settlements and elsewhere, and other arrangements will be examined.

Jaffe: Welcome to our session on the Pension Protection Act, VEBAs, and a number of other issues related to health and retirement benefits and current trends, problems, and issues that many of us will face in the upcoming year and thereafter.

My name is Ira Jaffe. I have the pleasure of serving as co-moderator of this session. David Vaughn, Academy Member, will also serve as co-moderator; he also will be presenting with respect to the area of VEBAs

Another distinguished panelist is Harry Burton. He is an Employee Retirement Insurance Security Act (ERISA) lawyer and a labor lawyer. He's a partner with the firm of Morgan, Lewis, and Bockius out of their Washington, D.C., office. Harry's practice has involved advising employers and also employee benefit plans regarding all areas of collective bargaining and benefit plan operations. That includes a significant chunk of the practice dealing with bargaining issues. Harry recently concluded a round of

bargaining with the Washington, D.C., area supermarkets and the United Food and Commercial workers that involved a series of health and other benefit issues.

Jani Rachelson is a partner with the New York law firm of Cohen, Weiss, and Simon. She's senior partner in charge of the benefits practice. I know she's done a lot of work not only with a variety of plans in a number of industries but also with the American Bar Association (ABA) for many years in terms of attendance at the employee benefits meetings and also updated work on the employee benefits law that's published by BNA and prepared by the ABA.

We are very fortunate to have them with us today to educate us on an area of the law that is extraordinarily complicated and technical.

We want to do this in an interactive format. Among other things, it will make sure that we try to cover those areas that are of greatest interest to each of you. I'm going to deliver just a few very brief comments on the big-picture overview of trend issues dealing with the provision of health and retirement benefits. Then Dave Vaughn will speak on the subject of VEBAs.

With respect to health care trends—and this interrelates to some extent to VEBAs, anyone who's done any work in the field knows that this has been an area of extraordinary contention over the past half-dozen years. And there are a number of reasons for it, not the least of which is that costs have exploded in the past decade far out of proportion to wages, generally, or the overall rate of underlying inflation on behalf of other items.

As a result, we've seen a number of design changes implemented in health plans that are employer-provided. And in toto, what they do is shift a much greater responsibility for providing health benefits onto the shoulders—or the backs as the case may be—of the covered employees and their family members.

Beyond the bargaining issues, there's much lower utilization of health care benefits, particularly among the part-time and the lower-wage employees who can no longer afford even their share of the contributions that are needed, the deductibles that they now need to pay, which have increased significantly in amount.

We've seen a number of other changes as well, such as preventive care benefits, incentives and penalties for healthy and unhealthy behaviors, greater communication in terms of Web-based information, health-related discounts and affiliations, and the ability

to join a gym at a reduced rate, all as a means of attempting to control to some degree the spiraling costs of health care. We've also seen significant reductions in the area of benefits provided to retirees and a related number of lawsuits and other legal issues surrounding those cutbacks.

In terms of retirement benefit trends, the traditionally defined benefit pension plan provides benefits in the form of annuities for life. These plans frequently have built-in protection for inflation. And as wages go up, the benefits go up. The Pension Benefit Guarantee Corporation (PBGC) makes sure that those benefits that have been promised ultimately wind up being paid to participants.

There's been a major shift in recent years to defined contribution plans, similar to 401(k)s and individual retirement accounts (IRAs). The amount that people receive by way of benefits is that which has been placed in their individual accounts and what they're worth based on earnings of those monies. As longevity increases, these plans cover less and less of the replacement portion of income that might otherwise have been provided if this had been through a traditional, defined-benefit model.

Funding issues have existed for a number of years with the multi-employer plans as well. This is largely because, even in the defined-benefit universe, you don't pay for the full cost of the benefits up front. They're funded over a period of years. They're based on an assumption that there will be a continuing flow of new contributions based on new covered employment, including on behalf of people who never earn the right to receive any benefits under the plans.

In 1980, Congress enacted the Multi-Employer Pension Plan Amendments Act, which essentially provided that if employers pulled out of these plans, if they weren't fully funded, then they were required to make withdrawal liability payments as a means of protecting the plans from the exodus of the future contributions that were part of the underpinning for the financial solvency of a plan.

In 2006, Congress passed the most significant set of changes enacted since ERISA was passed in 1974, PPA. The law is more than 900 pages in printed bill form. There was a committee report that was several hundred pages in size as well. An enormous amount of new regulations, technical guidance, and the like is still being promulgated in various forms. One reference for Employee Benefits

Standards Administration information is the Department of Labor Web page,[1] which has links to an enormous amount of data.

I'm not going to go through the major portions of the PPA. I will note only that they provide for significantly greater obligations on the part of contributing employers to fund the plans fully in much less time than was the case under the prior rules. And this was done with a goal, in part at least, of protecting the insurance-backed PBGC. The goal is, if the plans are fully funded at a much earlier date, there's much less exposure of the PBGCs in the event that things go south at a given employer or given plan.

There are changes in the way one measures the financial status of a plan. And this will have some impact in terms of the number of the PPA issues that we are going to be discussing. But essentially, although there's still a fair amount of discretion on the part of the actuaries to these funds, the discretion has been narrowed somewhat in several areas, not the least of which includes how they select interest rates and also what they use by way of mortality assumptions. These two areas have significant impact on what the overall projected value of the liabilities are and, as a result, the overall amount of money that needs to be put into the plans in order to fund these benefit commitments.

There are changes that provide for much greater information to employers, participants, and others. There's a push towards adoption and greater use of defined contribution plans, including provisions for automatic enrollment. There are also special rules with respect to prohibited transactions, including transfers of assets between pension plans and health plans, increased deduction limits, special rules for multi-employer plans, and the like.

As we go through the next set of negotiations in a variety of industries, these issues are going to be at the forefront. There's going to be tremendous economic impact on bargaining parties and tremendous interest on the part of unions and their members because they're going to get hit in the pocketbook by these changes.

Without further ado, let me turn it over to David Vaughn. Thank you.

Vaughn: Thank you, Ira. Ira is my close friend and a bright light in the Academy, especially on pension and benefit issues.

I'm going to focus on the adoption in 2007 by the Big Three Detroit auto companies and the UAW of new provisions that affect

[1]www.dol.gov/ebsa/pensionreform.html.

the health care benefits of retirees through the establishment of a Voluntary Employee Beneficiary Association, a VEBA, to fund and administer those benefits. These VEBAs brought a new visibility and new uses to a mechanism that has been available for almost a century.

My presentation will define a VEBA, describe the circumstances that led to the creation of the auto industry VEBA, the problems that the parties sought to address, and the manner in which the VEBA will operate. I will identify some of the risks in the strategy of using VEBAs and the implications for other industries. Although the adoption of VEBAs is an exercise in collective bargaining under difficult conditions in the auto industry, it has been used in other industries and in public-sector entities.

Over the last decade, health care costs have increased at double the rate of inflation. Meanwhile, profitability and financial stability in many traditional industries have eroded. It's expected that health care costs will continue to increase into the foreseeable future and will constitute an ever-increasing component of employee compensation.

If health care, generally, has been a difficult area in contract negotiations and administration, then health care benefits for retirees have been even more so. Those benefits were originally negotiated almost as throw-ins with health insurance for active employees when they first were implemented. But their continuation presents certain special challenges even above and beyond the overall costs of health care. Workers retire earlier, live longer, and use more health care services than previous generations of retirees. Moreover, retiree health care costs are strictly an overhead expense rather than being a function of production. At the time most retiree health benefits were negotiated, employment was stable or increasing. And there were few retirees relative to the size of the active workforce. So the profits of the work of many employees could fund each retiree's health benefits.

As the workforce has aged, as industries have automated and downsized, the ratio of active employees to retirees has changed. Buyouts and early retirements have increased that shift. And there are far fewer active employees presently to support benefits paid to retirees than in the past.

The impact of these demographic changes on the real costs of retiree health benefits has been brutal. In the auto industry, retiree health benefits add approximately $1,500 to the cost of each General Motors car and $1,100 to the cost of each Ford. By

comparison, cars built in Asia have only about $450 in such costs. Even the so-called "transplants," the American factories where foreign name-plate cars are built, lack comparable benefits to what the Big Three have and have, as a general rule, much younger work forces.

As if these costs were not enough to raise concerns and require response, changes in accounting standards, which govern both private- and public-sector entities, require employers to account for and set aside monies to fund the past service liabilities for benefits due present and future retirees, the so-called legacy cost. Financial Accounting Standards Board Rule 106 requires recognition of these obligations for private employers. Government Accounting Standard Board Rule 45, which is now being phased in, places a similar obligation on public employers.

These rules mean that employers must carry the costs of future retiree health benefits as a liability on their books. When you accumulate the obligations of thousands of dollars per year of costs for each employee times the thousands of retirees times dozens of years, the cumulative liability of the Big Three auto makers approximates $100 billion.

The requirements reduce profits, restrict cash flow, raise the cost of borrowing, and, in extreme circumstances, may threaten the solvency of a company. The concern is not confined to stock analysts, lenders, and bond rating companies. Unions of the retirees on whose behalf they bargain recognize the insecurity of health benefits to be provided by a shaky employer. If a company goes into bankruptcy, benefits may be curtailed or extinguished in concession bargaining or imposed by a bankruptcy court. And retirees may well be left with reduced benefits or none at all.

A separate problem that threatens retiree health benefits provided through collective bargaining agreements is that those agreements expire at the end of their term or at some point set by law. Retiree health benefits provided for in a contract may expire with that contract. But retirees expect and need lifetime coverage when they retire. Permanence is difficult to achieve in bargaining and may be difficult to enforce beyond the term of a particular contract even if the employer remains solvent and even if lifetime benefits are implied in the agreement. The courts are split as to whether retiree health benefits survive the expiration of a contract. And many courts are reluctant to infer the existence of such a commitment.

As indicated, the Big Three have funded their retiree health benefits through a VEBA. And let me talk a little bit about what a VEBA is. It is simply a funding mechanism for one or more underlying plans through which retiree health benefits can be provided. It's generally operated through a trust document. It is not a plan. And the methods for delivering benefits and the benefit levels and the conditions for participant participation are ordinarily bargained separately through the collective bargaining agreement and may be carried forward from previous structures or left for later determination.

Although VEBAs have achieved visibility as a result of their recent adoption in the auto industry and in several other major industries, they've been available and regularly used for many years. There are approximately 12,000 VEBAs in the country. Some are very large; most are very small. VEBAs are tax-exempt organizations that may be established pursuant to Section 501(c)(9) of the Internal Revenue Code. Employer contributions to VEBAs are, as a general matter, tax deductible. And earnings on assets in collectively bargained VEBAs are tax exempt. Benefit payments from a VEBA are non-taxable for unionized employers. So they really are a remarkable vehicle because they basically allow employers to put in money-free assets to grow free and benefits to be paid for free. In collective bargaining situations, benefits can be pre-funded, as is the case in the auto industry benefits. So there are opportunities for employers to regulate cash flow.

VEBAs are almost always set up as trusts. Trustees are responsible to manage the trust assets, the contributions that are put in from whatever source in accordance with the purposes of the trust, except as that responsibility may be delegated to named fiduciaries or to investment managers appointed by the fiduciary.

In the auto industry's situation—although there were three separate sets of negotiations—I understand that a single VEBA will administer separate accounts. For each of the three companies, they'll be funded separately by each company; and they will separately provide benefits to that company's retirees. There is one set of 11 trustees, 5 of whom are appointed by the union, and the remainder of whom are neutral, expert outsiders.

As indicated, the creation of these new VEBAs was necessitated by the huge, growing and uncertain, unfunded liabilities of the employers for the ever-decreasing ratio of active employees relative to retirees and by the accounting standards that require

companies to carry on the books the unfunded, projected future liabilities to provide benefits. It's become very important for many employers to reduce and control those liabilities and get them off their books. Transferring them to a VEBA accomplishes that purpose subject to certain approvals by the regulators and by the courts.

So what's in it for the unions whose retirees presently receive benefits and whose members are projected to do so in the future? The answer lies, at least in part, in the concern of unions and beneficiaries alike that the unions may, in the future, or even now, lack the power in bargaining to require employers to maintain the benefits or that an employer may go bankrupt or go out of business or engage in some other transaction that allows it to escape much or all of the liability for these benefits, leaving retirees without coverage or with reduced coverage.

Moving the funding insulates the assets used to fund the benefits from the reach of the company or from its creditors. It's a one-way transaction. The company cannot get the money back once it's sent to a VEBA. Moreover, by providing retiree health benefits independent of the collective bargaining agreement, questions as to the permanence of such benefits can be better addressed.

This seems like a win/win situation for the parties; but it's not that simple. The entire exercise of moving retiree health costs and benefits outside of the company and outside of the collective bargaining agreement and off the books has all of the elements of an unrehearsed high-wire act. I note that the liabilities that the VEBAs are assuming are huge. The funding to be provided by the companies may not be sufficient to meet future liabilities. And although part of the funding in the auto industry VEBAs is, or will be, in cash or cash equivalents, much of the complex funding is in the form of—or convertible to—company stocks and various types of notes. And the value of those contributions made and to be made carries with it uncertainty. The value of the securities may decline. And because the notes are a future promise to pay and subject to the uncertainties that future obligations carry, there's a potential upside if the companies prosper and the stock price goes up. But that is a risk.

Moreover, the funding levels to which the parties agreed assume 9 percent returns on assets held by the VEBA and only 5 percent annual increases in health care costs. And those are rosy numbers going into a troubled economic and political environment. The

numbers include various actuarial assumptions regarding participation, longevity, and other parameters that may or may not be borne out.

Deviations from almost any of these assumptions may require curtailments of benefits and/or increased beneficiary participation, either through collective bargaining or from actions of the trust or from actions of some external entity such as a bankruptcy court. To extend the high-wire analogy, there is little safety net available if the projections turn out to be wrong.

The creation of VEBAs and the transfer of responsibility for retiree health care to the VEBAs impacts on the rights and obligations of a number of different entities and groups: the employer, the union, current active beneficiaries, future retirees, and, obviously, other people who may be impacted by the overall health of the company. So the viability of the VEBAs is not only a function of governance, but is dependent on various rulings from the Internal Revenue Service (IRS), the Department of Labor, the Securities and Exchange Commission, and the courts. Unfavorable rulings from any of those regulatory agencies or from a court can easily sink a VEBA's little boat.

Completion of the litigation and the regulatory review process that is now underway for the auto industry VEBAs will be complete in January 2010—quite a long way from 2007 when they were negotiated. In the meantime, their liabilities stay on the books of the company. And the risk to the participants continues.

Courts have generally allowed beneficiaries to challenge the creation of VEBAs even when entered into between the company and union or as a result of bankruptcy or other litigation. Indeed, the activation of the auto industry VEBAs is subject to a complex process including litigation where an attorney designated to represent current beneficiaries files suit to determine whether the company's obligation to provide benefits is for life. And the court engages in a process of evaluation to determine whether the VEBA adequately protects beneficiaries and ultimately, as has been the case in each of the three automobile industry agreements, has been approved.

Now, as students of collective bargaining, it's important to look beyond these particular VEBAs to note that this is an extremely flexible vehicle. It is useable potentially to provide not only retiree health benefits, but also other forms of benefits that may gain from similar kinds of considerations. In the auto industry, obviously,

you're dealing with a bargaining process. And, where parties are operating under duress, it is conceivable there may be other situations with different parameters where VEBAs would be useful.

Interestingly enough, the emergence of Government Accounting Standard Board Rule 45, which places truth in financial statements obligations on public entities, may push governmental units toward funding part of the benefits that they have through VEBAs. Obviously, governmental entities do not have the tax deductibility of damages that a for-profit company might have. But there are other advantages and there may be alternate methods of funding government-established VEBAs.

So this is a very flexible method of funding. The particular VEBAs I described came about as a result of very special circumstances. But they can be used in a variety of other situations.

Thank you very much.

Burton: David has been talking about a private, collectively bargained structure that will continue to be used and will spawn more private structures. Jani and I are going to talk about a federal statutory structure that's being imposed, which may spawn changes in the way we approach collective bargaining.

I'm going to give a brief overview and then talk about how the Act likely will alter the current situation of collective bargaining in a very general way. And then Jani is going to do the really heavy lifting and go through some of the essential details. We're going to talk mostly about multi-employer pension plan situations, but some of the issues relate to single-employer plans as well.

Multi-employer pension plans continue to be organized under the Taft-Hartley Act, section 302(c)(5). They are in trusts. The trusts are separate legal entities from both collective bargaining parties. The trusts are jointly trusteed by management and labor. Congress had the fascinating idea back in 1947 that if they put management and labor on the board simultaneously and had no other structure, somehow through that interaction, truth and honesty would fall out. I think it was a pretty good idea.

So that is the legal structure. As a separate legal entity, the trustees are not directly engaged in collective bargaining. Their money comes from the collective bargaining parties. Typically, the collective bargaining agreement in a multi-employer context will have only a contribution obligation; it will not settle both contribution and benefit.

The trustees, typically, set the benefits. The trustees, however, are third-party beneficiaries of the collective bargaining agree-

ment. So the status quo without the Act and without ERISA is that the trustees can sue on that collectively bargained promise because they're third-party beneficiaries. That's the structure in the prior law. That much continues to be the structure in the new law under the PPA.

What is changing under the PPA? Let's use an example to give us what I think is one of the more fundamental structural changes: In the old law—let's assume that we were in bargaining and we agreed to bargain a dollar-an-hour pension fund contribution as bargaining parties. That dollar-an-hour goes into the pension trust fund. The trustees sit down and hire an actuary to figure out how much benefit they could provide over the lives of people for that dollar-an-hour. So all the really important detail work is done at the trust fund level.

Suppose our actuary on the trust fund proved to be wrong or was right and circumstances simply changed: The cash flow reduced, we got less for our investments. So now we have a plan that could be drifting toward problems under the tax code and under ERISA. The real trouble under the tax code and ERISA is a so-called funding deficiency. It's a bad place to be.

Let's assume, for the sake of argument, that the mistakes or the bad fortune had gotten so bad that we're facing a funding deficiency in the trust fund. Logic might tell us that the remedy for a funding deficiency—given the fact that the bargaining parties have put in all their contribution obligations—the laws should say that the people who are responsible for the error and who've had the misfortune through investments, let's say, should be the remedy. That's where the remedy should lie. That logical approach is changed only by the PPA.

What would happen in that situation is that the fund is drifting into funding deficiency endangered status under the PPA. The remedy under the tax code if the trustees are in a funding deficiency comes back to the contributing employers with an excise tax.

The IRS literally says to the contributing employers: "There's not enough money in this fund. The trustees have promised this benefit. It can't be funded. You're not allowed to cut it back retroactively. So if you do not put more money—despite your collective bargaining obligation—into that trust fund to solve the problem, we will tax you an excise tax." The excise tax goes into the treasury. It does not go into the fund. And so the employers decide they have to go beyond their bargaining obligation.

In the real world, that has happened very rarely for a couple of reasons. Most of these funds, up until the early 2000s, when the markets hit a bad place, have been in pretty good shape. That's one reason. The other reason is the collective bargaining process and the fact that bargaining parties don't have a death wish out there. So when the tax man comes asking for money, typically, the bargaining parties sit down and try to work something out. The worst case is the employers just have to pay.

So that's the anomaly that has existed from the beginning of these plans, really, since ERISA anyway and funding obligations. And that anomaly is now being changed. The system I just described was, at least, a one-way process involving bargaining of your cash flow into a trust fund and the bargaining parties having very little to do with whatever happened to the trust fund unless, of course, they happen to be appointed trustees.

What the law is doing now is putting more stringent requirements on the trust fund and the actuary to establish where the plan is and also to publish it to employers, to employees, to bargaining unions. The trustees, when they get into trouble, are required to come up with a plan that will, hopefully, work out the funding deficiency under these new measures over a period, typically ten years.

The Act's funding requirements are much more stringent than they were before. That's the negative side of the process. It's going to take more of the collective bargaining pie to take care of these problems. The upside is I think it's a much more rational process, because it involves the bargaining parties in the solution and not just the tax man.

Rachelson: I want to react to a couple of things that Harry said. And one is that it may depend on your primary practice. For instance, I think Harry does a lot more labor negotiations than I do. I represent funds. My personal work has always been in the Taft-Hartley area and representing funds. In the past, if the fund got into trouble, the employers were the ones who had to pay. My reaction is that's good. We don't want to do anything. We want the employers to pay because that's where I come from, from the fund. We don't want to have to cut the benefits if we don't have to. We want the employers to have to bear that burden.

The secrecy Harry described was a bad thing for employers; but it was a fact of life. And now, all of a sudden, transparency is the by-word; everybody needs to know everything. And it's going to help in some ways. But what it could do, potentially, is create a lot

of damage, a lot of trouble. Any employer that wants to make trouble, any union dissident who wants to make trouble, everybody's going to have a lot of fodder; a lot of trees are going to die; there's going to be a lot of duplicated actuarial reports. And actuaries are not going to tell trustees what they used to tell them because they don't want to have to put that in writing that's going to go off to people.

The one thing I'm a little more sanguine about, I see the union trustees and the employer trustees equally trying to work this out. And everybody knows there are going to be cuts. Unfortunately, in this day and age, there aren't too many rich companies out there dealing with these things. If they're rich companies, then the plans aren't in trouble. If the plans are in trouble, then the companies are going under, the unions recognize it's going to come out of their hide one way or the other, and they are going to work with the employers. And as counsel to a fund, we're trying to get everybody to work together because we don't want an arbitrator figuring out what our schedule's going to be. We should figure it out ourselves with the advice of our actuaries.

For a plan that's endangered or seriously endangered, the trustees have to adopt something called a funding improvement plan. Now, this is a plan that's going to be under 80 percent funded or facing a funding deficiency within the current year or six years out. If it's seriously endangered, it's got both of those. The funding improvement plan is really not so drastic. Because under the current law, if you were facing a funding deficiency next year, you would have to do everything in your power—cut everything to zero right now and make sure you don't have a funding deficiency. Because, as Harry said, that's a bad place to be.

Current law—the new law says you could have that funding deficiency. And it gives you ten years to work out of it. And for a plan that's below 80 percent but above 65, it says, all you have to do is increase the funded percentage by a third of the difference between 100 percent and wherever you are over ten years. Let's say you're 75 percent funded. That means you're 25 percent underfunded. You have to increase it by a third of 25 percent, which is $8^{1}/_{3}$.

Eight and a third, in ten years. So you don't have to be 80 percent the next year. You can have a funding deficiency. You just need to go slowly. I had a client right before the law went into effect where the management trustees had a contract expiring in August of the first year. The management trustees said, "We are

not going to have a funding deficiency. We don't care that the new rule would allow you to do it more gradually." So they forced the union to accept a huge cut in benefits right up front, all in one year, so that they would be much better funded. And I was arguing, as the union co-counsel, "We don't have to do this. Let's wait and see. Take our time. Be more moderate."

So for plans that are on the cusp, this law actually will help you because you can do things in a gradual way. Now, I think it's very cumbersome how it's actually going to work out. Sending out different schedules of contribution increases and benefit cuts to 2, 10, 15, 2,000 bargaining parties is going to be a nightmare. I don't know how that's going to work. We haven't gotten there on any of my plans, yet. But I think that in the long run, the fact that you can do a gradual improvement helps you out of a problem.

Jaffe: Let me thank the panel.