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VEBAS TO THE RESCUE: EVALUATING ONE ALTERNATIVE FOR PUBLIC SECTOR RETIREE HEALTH BENEFITS

SUSAN E. CANCELOSI*

INTRODUCTION

Accounting rules have long enabled public sector employers to maintain an ostrich approach to retiree health plan commitments even as their private counterparts reduced or terminated similar benefits. Over the past few years, however, a new accounting standard has forced government plan sponsors to face their accumulating liability and has pushed them to seek solutions. The problems facing the public sector are not new. In fact, the circumstances they face today bear striking similarities to the situation in which many large, traditional manufacturing companies found themselves in the early 1990s. The private sector's retiree health crisis of almost two decades ago led to a new variation on an old trust concept: a version of voluntary employees' beneficiary association—or "VEBA"—now known as a "defeasance" or "stand-alone" VEBA. Although widely publicized¹ in recent years because of its embrace by the Detroit automakers² and the

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1. See, e.g., Nick Bunkley & Mary M. Chapman, *Off the Picket Line at G.M., Relieved but Wary*, N.Y. TIMES, Sept. 27, 2007, at C1 ("Under the tentative contract, health care liabilities will be shifted from G.M.[sic] to the union as part of a new trust known as a voluntary employee benefit association, or VEBA."); Sholnn Freeman & Frank Ahrens, *GM, Union Agree on Contract to End Strike; Deal Seen as Model Across Industries*, WASH. POST, Sept. 27, 2007, at A1 ("Under the new contract, UAW retiree benefits will be paid out by a voluntary employees' beneficiary association (VEBA).").

2. References to the "Detroit automakers" or to the "Detroit Big Three" should be interpreted to mean Chrysler Group LLC ("Chrysler"), Ford Motor Company ("Ford"), and General Motors Corp. ("GM") as these companies existed before the 2009 bankruptcy filings and subsequent restructuring of

UAW,³ the stand-alone VEBA model has not been considered seriously as an option for the public sector, but it should be. The challenges that government employers face today closely parallel those confronting certain private sector employers since the early 1990s. In light of the parallels, the defeasance VEBA structure deserves discussion in the public sector.

Employers began promising retiree health benefits around the middle of the last century. In the early decades of retiree health insurance, employers apparently perceived retiree health benefit costs as negligible. Because no accounting requirements forced recognition of future costs, both private and public employers made generous, open-ended promises. Not until an accounting rule change in the early 1990s—Financial Accounting Standards Board Statement of Financial Accounting No. 106 (“FAS 106”)⁴—required current balance sheet recognition of retiree health benefit commitments did private sector employers grasp the enormity of their past grants. A similar accounting rule change in the final phases of implementation for government employers—Government Accounting Standards Board Statement No. 45 (“GASB 45”)⁵—has generated a comparable shock wave in the public sector.

When private sector employers realized the impact of FAS 106 on their balance sheets, many chose to terminate retiree health benefits. Others imposed a variety of cost-containment measures. Collectively bargained employers, however, generally could not take such steps. Constrained by their agreements with unions, they had little flexibility in managing their retiree health expenses. Large, traditional manufacturing companies—with high concentrations of unionized retirees and historically generous benefit packages, but shrinking active workforces and negative economic forecasts—found themselves struggling to remain financially viable in the face of overwhelming liabilities.

The public sector today faces similar problems. Because GASB 45 demands that government employers acknowledge the true level of retiree health offers, they risk balance sheet disasters.

both Chrysler and GM.

3. The “UAW” is the commonly used acronym for the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America. See *About the UAW, Who We Are*, <http://www.uaw.org/about/uawmembership.cfm> (last visited July 8, 2009).

4. FINANCIAL ACCOUNTING STANDARDS BOARD (“FASB”), STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 106, EMPLOYERS’ ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS (1990) [hereinafter FAS 106].

5. GOV’T ACCOUNTING STANDARDS BOARD (“GASB”), STATEMENT NO. 45, ACCOUNTING AND FINANCIAL REPORTING BY EMPLOYERS FOR POSTEMPLOYMENT BENEFITS OTHER THAN PENSIONS (2004) [hereinafter GASB 45].

Most have financed retiree health benefits on a pay-as-you-go basis, with no assets set aside for future expenses. Many are heavily unionized, with little room to shift costs to retirees, much less to terminate benefits. Some have constitutional or statutory guarantees that protect benefit commitments. Although they do not risk liquidation the way private sector employers do, financial insolvency affects state and local governments' ability to raise money to finance public services and projects. Government employers, moreover, depend on the good will of taxpayers. They cannot easily raise taxes or divert funds from other sources. Meanwhile, the current depressed economy translates to severe budget problems for state and local governments across the country.

The similarities between the public sector today and the private sector of the early 1990s raise intriguing questions about possible solutions for the public sector. A number of large manufacturing companies over the past two decades have turned to defeasance VEBAs as a way to relieve crushing retiree health benefit liabilities. VEBAs have existed in the Internal Revenue Code (the "Code") since 1928 and have roots in employee-driven "sickness" funds that go back into the 1800s. The traditional VEBA under the Code is a type of tax-exempt trust in which assets may accumulate free of federal income tax to fund certain kinds of benefits, particularly health benefits. For most of VEBA history, the trusts have been linked to employer-sponsored health insurance plans, with employers in control of the terms and conditions of the insurance benefits and the VEBAs' functioning primarily as funding mechanisms. The defeasance model, however, moves beyond the traditional style of VEBA to establish an independent trust offering health benefits, separate from an employer plan, under the control of an independent board ultimately responsible to VEBA participants.

This Article provides perspective on defeasance VEBAs as a potential solution for public sector retiree health benefit commitments. Toward this end, Section I describes the development of employment-based health insurance and retiree health benefits in both the public and private sectors. Section II provides an overview of the problems that eventually arose to threaten the provision of retiree health benefits, particularly in the wake of FAS 106 and GASB 45. Section III surveys private sector employer responses to FAS 106 and possible public sector employer responses to GASB 45. Section IV discusses VEBAs, giving both background on traditional VEBAs and explaining the rise of the defeasance VEBA model. Section V then compares the situation in which public sector employers today find themselves with the circumstances that prompted the rise of the stand-alone VEBA in the private sector, highlighting the distinct similarities

between the two.

I. RETIREE HEALTH BENEFITS, PUBLIC AND PRIVATE

A. Background

The employer-sponsored health insurance system had been developing slowly in the United States, but became entrenched following World War II.⁶ After 1950, when a series of collective bargaining agreements between the UAW and the Detroit Big Three established health insurance as a standard employee benefit for union employees,⁷ coverage under employer-sponsored insurance expanded steadily. An estimated ninety-three million individuals participated in employer-sponsored health plans by 1958;⁸ employer plans covered more than 60% of the active private sector workforce by 1964;⁹ and more than 70% of the non-elderly population enjoyed employment-based health coverage by 1977.¹⁰ Throughout the 1960s and 1970s, employers appear to have remained relatively unconcerned about the cost of health benefits.¹¹ Eventually, however, exploding costs reversed coverage

6. COLIN GORDON, *DEAD ON ARRIVAL* 21 (2003) (reporting that at least two-thirds of employers with more than 250 employees, and more than 50% of smaller employers, sponsored health insurance plans by the late 1940s). For a range of discussions of the growth of the U.S. employment-based health insurance system, see JENNIFER KLEIN, *FOR ALL THESE RIGHTS: BUSINESS, LABOR, AND THE SHAPING OF AMERICA'S PUBLIC-PRIVATE WELFARE STATE* (2003); INSTITUTE OF MEDICINE, *EMPLOYMENT AND HEALTH BENEFITS: A CONNECTION AT RISK* (Marilyn J. Field & Harold T. Shapiro eds., 1993) [hereinafter IOM]; JOHN E. MURRAY, *ORIGINS OF AMERICAN HEALTH INSURANCE: A HISTORY OF INDUSTRIAL SICKNESS FUNDS* (2007); JILL QUADAGNO, *ONE NATION, UNINSURED* (2005); PAUL STARR, *THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE* (1982).

7. See Teresa Ghilarducci, *The New Treaty of Detroit: Are VEBA's Labor's Way Forward?*, *LABOR IN THE ERA OF GLOBALIZATION* 241 (Clair Brown et al. eds., 2009) (discussing the five-year collective bargaining agreements between the automakers and workers in which the workers agreed not to strike in exchange for productivity-based wages).

8. IOM, *supra* note 6, at 71.

9. GORDON, *supra* note 6, at 29.

10. Jon R. Gabel, *Job-Based Health Insurance, 1977-1998: The Accidental System Under Scrutiny*, 18 *HEALTH AFF.* 62, 65, ex. 1 (1999) (estimating that, in 1977, 70.5% of the non-elderly population had employment-based coverage). Coverage levels remained stable through most of the 1980s: in 1987, an estimated 70.9% of the non-elderly population had employment-based coverage. *Id.*

11. See, e.g., Michael S. Gordon, *Introduction to the Second Edition: ERISA in the 21st Century*, *EMP. BENEFITS LAW*, at lxviii (Steven J. Sacher et al. eds., 2d ed. 2000) ("Unlike pension plans, there was no crisis in health plans in 1974 Nor was there evidence of potentially out-of-control medical cost inflation, nor of new and dramatically high-priced medical technologies, the use of which would become the norm, rather than the exception [E]mployer-provided health insurance was cheap and plentiful."). This

trends in the private sector.¹² From 1960 through 2008, employers moved from spending approximately \$25 billion per year on group health insurance policies to \$545 billion.¹³ By 2006, only about 55% of the non-elderly population still enjoyed employer-sponsored health coverage.¹⁴

Many state government employee health insurance plans originated during the same mid-century era as private sector plans.¹⁵ For example, Alabama enacted legislation creating its

situation may help explain the concurrent expansion of retiree health benefits. *Id.*; see *infra* notes 36-52 and accompanying text.

12. See, e.g., Alain C. Enthoven & Victor R. Fuchs, *Employment-Based Health Insurance: Past, Present and Future*, 25 HEALTH AFF. 1538, 1539 (2006) (discussing how employment-based coverage peaked in the 1980s and has since declined). LISA CLEMENS COPE & BOWEN GARRETT, HENRY J. KAISER FAM. FOUND., CHANGES IN EMPLOYER-SPONSORED HEALTH INSURANCE SPONSORSHIP, ELIGIBILITY, AND PARTICIPATION: 2001 TO 2005 13 (2006), available at <http://www.kff.org/uninsured/upload/7599.pdf> (reviewing the declining levels of employer-sponsored coverage in the early 2000s).

13. HENRY J. KAISER FAM. FOUND., WAGES AND BENEFITS: A LONG-TERM VIEW (Nov. 2008), <http://www.kff.org/insurance/snapshot/chcm012808oth.cfm#front3>.

14. U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE U.S.: 2006 58, tbl. C-1 (2007). It is important to distinguish between having “access to medical benefits” and having “coverage.” More individuals are eligible to elect health insurance through an employer than actually choose to do so, whether for financial or other reasons. See, e.g., U.S. Dep’t of Labor, Bureau of Labor Statistics (“BLS”), *Economic News Release: Employee Benefits in the U.S., Mar. 2009*, July 28, 2009, <http://www.bls.gov/news.release/ebs2.nr0.htm> [hereinafter BLS *Economic News Release*] (reporting that approximately 70% of U.S. private sector employees had access to employment-based coverage in March 2009).

15. National Conference of State Legislatures, State Employee Health Benefits, <http://www.ncsl.org/programs/health/stateemploy.htm> (last visited Dec. 22, 2009) (noting that most states have provided health insurance benefits to employees for “decades”). Some states may have allowed state agencies to negotiate their own benefit packages but did not consolidate the programs into single state-wide employee health insurance plans until the 1970s. For example, before July 1974, individual state agencies negotiated their own benefits packages in Idaho; the state consolidated those efforts into a single state employees’ benefit plan effective for the 1975 fiscal year. See OFFICE OF INS. MGMT., STATE EMPLOYEE INSURANCE BENEFITS, FACT SHEET 1 (Jan. 2002), available at <http://adm.idaho.gov/insurance/grp/Factsheet1-02.pdf>. See also NORTH DAKOTA PUBLIC EMPLOYEES RETIREMENT SYSTEM, COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2008 5 (Nov. 28, 2008), available at <http://www.nd.gov/ndpers/forms-and-publications/publications/2008-annual-report.pdf> (indicating that North Dakota implemented its group health insurance plan for active and retired employees in 1971); Or. Rev. Stat. § 243-135 (1971) (indicating that Oregon did the same); Employees Retirement System of Texas, *History of ERS*, <http://www.ers.state.tx.us/htdocs/about/history/default.aspx> (last visited Mar. 14, 2009) (stating that Texas implemented its consolidated group health insurance plan for state employees in 1975); WEST VIRGINIA PUBLIC EMPLOYEES INSURANCE AGENCY, COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE FISCAL YEAR ENDED JUNE 30, 2003 1 (2003) (reporting that

State Employees' Insurance Board in 1965.¹⁶ California extended health insurance benefits to state employees in 1962.¹⁷ Louisiana in 1950 authorized state agencies to pursue health benefits for state employees; by 1970, the legislature had consolidated state employee health insurance benefits.¹⁸ Massachusetts established its Group Insurance Commission in 1955 to provide health insurance benefits, among other benefits, to state employees.¹⁹ As early as 1943, Nevada permitted local governmental entities to establish group health insurance plans for employees.²⁰ A state-wide Public Employees' Benefit Program was established in 1963.²¹ New Jersey created the Division of Pensions and Benefits in 1955 to administer its retirement funds and State Health Benefits Plan.²² New York established its New York State Health Insurance Plan for state employees in 1957.²³ Utah implemented a state employees' health plan in 1961—today known as the Public Employees Health Program—through the Group Insurance Division in the Utah State Department of Finance.²⁴ Wisconsin created a Group Insurance Board in 1959 to oversee state employee health and life insurance benefits.²⁵

Government benefits have traditionally been generous. Public sector employers contend that government compensation rates are lower than those in the private sector and that benefits must be comparatively more generous to attract and retain

West Virginia established its Public Employees Insurance Agency in 1971).

16. 1965 Ala. Laws 833. See also Alabama State Employees' Insurance Board, State Employees' Insurance Board, <http://www.alseib.org/About/> (last visited Mar. 14, 2009) (describing the establishment of Alabama's Insurance Board).

17. Cal. Public Employees Retirement System, *Facts at a Glance: General*, Sept. 2009, <http://www.calpers.ca.gov/eipdocs/about/facts/general.pdf>.

18. Office of Group Benefits, *OGB History*, <https://www.groupbenefits.org/portal/page/portal30/SHARED/O/OGBWEB/HISTORY> (last visited Mar. 14, 2009).

19. Mass. Exec. Office for Admin. & Finance, *Who is the GIC?*, [http://www.mass.gov/?pageID=afmodulechunk&L=4&L0=Home&L1=Insurance e+%26+Retirement&L2=Oversight+Agencies&L3=Group+Insurance+Commission&sid=Eoaf&b=terminalcontent&f=gic_whoisgic_who_is_gic&csid=Eoaf](http://www.mass.gov/?pageID=afmodulechunk&L=4&L0=Home&L1=Insurance+%26+Retirement&L2=Oversight+Agencies&L3=Group+Insurance+Commission&sid=Eoaf&b=terminalcontent&f=gic_whoisgic_who_is_gic&csid=Eoaf) (last visited Mar. 14, 2009).

20. Nev. Rev. Stat. § 287.010 (1943).

21. Nev. Rev. Stat. § 287.043 (1963).

22. N.J. Stat. Ann. § 52:18A-95 (2009); see also N.J. Dep't of Treas., Division of Pensions and Benefits, *Establishment of the Division*, <http://www.state.nj.us/treasury/pensions/index2.htm> (last visited Mar. 14, 2009) (describing the establishment of the Division).

23. New York State Dept. of Civil Service, *New York State Health Insurance Plan*, <http://www.cs.state.ny.us/nyship/nyship.cfm> (last visited Mar. 14, 2009).

24. Public Employees Health Plan, <http://www.pehp.org/> (last visited Mar. 14, 2009).

25. State of Wisconsin Department of Employee Trust Funds, 2006 Comprehensive Annual Financial Report (Dec. 15, 2008), available at http://etf.wi.gov/about/2006_cafr.pdf.

desirable employees.²⁶ A full 88% of all full-time state and local government employees thus had “access to . . . medical benefits” in March 2009, a much higher percentage than the 70% in the private sector.²⁷ Public employers also tend to shoulder more of the cost burden than private employers. Thus, for example, the Department of Labor’s Bureau of Labor Statistics in 2009 found that government employers offset a greater percentage (90%) of the cost of premiums for employee-only coverage than did private employers (80%).²⁸ In fact, according to one news report, public sector employers in 2007 spent about 72.8% more on benefits per employee than did private sector employers in the same period.²⁹

Notwithstanding their historic generosity, public employers are subject to the same healthcare cost challenges as their private counterparts. Many state government health plans have faced dramatic premium increases in recent years. For example, in 2002, premium costs increased in thirty-seven states by an average of about 12.8%.³⁰ As a result, state health plans have begun to increase co-payments and deductibles, and comparatively few now pay the entire premium cost even for employees.³¹ A number of states are also experimenting with more creative ways to reduce healthcare costs in an effort to manage expenses.³² For example, the National Conference of State Legislatures in 2009 reported at least nine states charge smokers higher premiums than non-smokers, and a number of states have implemented wellness programs, with and without financial incentives.³³

B. Expansion of Retiree Health Benefits

Retiree health benefits did not develop at the same pace as active employee insurance. Of individuals over age sixty-five in 1962 with some form of health insurance coverage, only 21% had coverage through a prior employer—i.e., retiree health

26. HENRY J. KAISER FAM. FOUND. & HEALTH RESEARCH AND EDUC. TRUST, EMPLOYER HEALTH BENEFITS: 2007 SUMMARY OF FINDINGS 1 (2007), <http://www.kff.org/insurance/7672/upload/Summary-of-Findings-EHBS-2007.pdf>.

27. BLS *Economic News Release*, *supra* note 14.

28. *Id.*

29. Jeremy Caplan, *Government Jobs Looking Better in the Downturn*, TIME, Nov. 22, 2008, available at <http://www.time.com/time/business/article/0,8599,1860886,00.html>.

30. HENRY J. KAISER FAM. FOUND. & HEALTH RESEARCH AND EDUC. TRUST, KAISER/HRET SURVEY 2002 STATE EMPLOYEE HEALTH PLANS 1 (2003), <http://www.kff.org/insurance/upload/Kaiser-HRET-Survey-2002-State-Employee-Health-Plans-Report.pdf>.

31. National Conference of State Legislatures, *supra* note 15. In 2009, only fourteen states covered the entire premium cost for “a basic or ‘standard’ health plan for some or all individual state employees.” *Id.*

32. *Id.*

33. *Id.*

insurance.³⁴ From the outset, retiree health benefits were much less generous than those available to active employees. For example, although the Detroit automakers in 1953 began to allow retirees age sixty-five or older to purchase the same health insurance available to active employees, the companies charged retirees the full price of that coverage.³⁵

After the mid-1960s, however, retiree health benefits expanded. There are a variety of possible explanations, and the growth in these benefits likely reflects some happy coincidence of factors. As a preliminary matter, employers through the early 1970s simply did not see health insurance benefits as a significant cost.³⁶ Insurers often contributed to this perception by treating retiree benefits as a no-additional-cost coverage item.³⁷ Then, the passage of Medicare in 1965³⁸ made retiree health benefits even less expensive for employers. Medicare amended the Social Security Act to create a national health insurance system that today covers the overwhelming majority of Americans age 65 and older.³⁹ Although Medicare does not provide comprehensive coverage,⁴⁰ it offers a substantial insurance foundation. With

34. SYLVESTER S. SCHIEBER, TIAA-CREF INSTITUTE, RECRUITMENT, RETENTION AND RETIREMENT: THE FUTURE OF RETIREE HEALTH BENEFITS IN HIGHER EDUCATION IN THE UNITED STATES 20 (2004), http://www.tiaa-crefinstitute.org/pdf/research/speeches_papers/040104d.pdf (citing Dorothy P. Rice, *Health Insurance of the Aged and Their Hospital Utilization in 1962: Findings of the 1963 Survey of the Aged*, 27 SOCIAL SECURITY BULLETIN 9 (1964)).

35. QUADAGNO, *supra* note 6, at 148. By the early 1960s, however, the UAW negotiated full benefits for union retirees at all three Detroit automakers. UAW, *Chronology: Social and Economic Progress for Autoworkers and America*, <http://www.uaw.org/barg/03/barg09.cfm> (last visited Aug. 19, 2008).

36. See GORDON, *supra* note 6, at 34.

37. Interview by Editor with Steven J. Sacher, Jones Day, *VEBAs: The Answer to Healthcare Benefit Costs for Retirees?*, Metropolitan Corp. Couns. 49 (Feb. 2008), available at <http://www.metrocorp counsel.com/pdf/2008/February/49.pdf> (“[I]n order to obtain the employer’s business in covering active employees, the insurance companies often agreed to cover retirees without additional cost to the employer. Needless to say, many employers accepted the offer.”).

38. Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286 (1965) (codified as amended at 42 U.S.C. § 1395-1395iii (2006)).

39. The statute provides Medicare to all “[i]ndividuals who are age sixty-five or over and are eligible for retirement benefits under subchapter II of [the Social Security Act] . . .” 42 U.S.C. § 1395c (2006).

40. Medicare beneficiaries remain subject to premiums, cost-sharing payments, benefit caps and deductibles; and in some cases—such as, most notably, prescription drug coverage before 2006—Medicare simply does not cover a particular type of expense. For example, under Medicare Part A (Medicare’s traditional hospitalization insurance), most beneficiaries do not pay a premium. 42 U.S.C. § 1395e (2006). They do, however, face a range of costs tied to a so-called “spell of illness.” 42 U.S.C. § 1395x(a) (2006). Those

Medicare as the base, employers could—and did—create relatively inexpensive retiree health benefit packages that supplemented the government system.⁴¹ Retirees typically remained on their employer plans, but the plans paid only after Medicare financed the first-dollar costs. Retiree health benefits thus became “wrap-around” plans. In its early years, Medicare contained relatively few limits on what providers could charge,⁴² a major cost issue for

costs in 2009 included a \$1,068 deductible for the first sixty days of inpatient hospital care, plus a \$267 per day co-payment for each of the next thirty days (days 61-90). After ninety days of inpatient hospital care in a spell of illness, the beneficiary begins to dip into what are called “lifetime reserve days” for which a beneficiary must pay a \$534 per day co-payment for any “lifetime reserve” days (days after the first ninety days of inpatient hospital care in any single spell of illness, limited to a maximum of sixty without regard to the number of spells of illness). CTRS. FOR MEDICARE AND MEDICARE SERVS., MEDICARE AND YOU 2009 112 (2008), available at <http://www.medicare.gov/Publications/Pubs/pdf/10050.pdf>. Under Medicare Part B (traditional Medicare’s coverage for physician and other provider services and equipment), beneficiaries pay an income-adjusted premium that in 2009 started at \$96.40 per month, plus an annual deductible (\$135 in 2009) and 20% co-insurance for most covered services and equipment. *Id.* at 119-21. As a result, even with Medicare, beneficiaries can quickly incur significant out-of-pocket costs. See, e.g., DAVID GROSS & NORMANDY BRANGAN, AARP PUB. POLICY INST., OUT-OF-POCKET SPENDING ON HEALTH CARE BY MEDICARE BENEFICIARIES AGE 65 AND OLDER: 1999 PROJECTIONS 1 (1999), http://assets.aarp.org/rgcenter/health/ib41_hspend.pdf. See generally MARILYN MOON, MEDICARE: A POLICY PRIMER (2006) (examining the history of Medicare and predictions for its future).

41. PATRICIA H. BORN & ALICE M. ZAWACKI, CTR. FOR ECON. STUDIES, U.S. BUREAU OF THE CENSUS, MANUFACTURING FIRMS’ DECISIONS REGARDING RETIREE HEALTH INSURANCE (2003), www.ces.census.gov/index.php/ces/cespapers?down_key=101680. See also SPECIAL COMMITTEE ON AGING, UNITED STATES SENATE, DEVELOPMENTS IN AGING: 1996, S. Rep. No. 105-36, at 191 (1997), available at http://thomas.loc.gov/cgi-bin/cpquery/35?&sid=c p105y827t&l_f=1&l_file=list/cp105cs.lst&hd_count=50&l_t=417&refer=&r_n=sr036v1.105&db_id=105&item=35&sel=TOC_613108& (“Employers could offer health benefits to their retirees with the assurance that the Federal Government would pay for many of the medical costs incurred by company retirees age 65 and older.”); ROBERT L. CLARK ET AL., THE ECONOMICS OF AN AGING SOCIETY 115 (2004) (noting that the availability of retiree health insurance, beginning in the 1960s, reduced the cost of retirement); Robert L. Clark et al., *Retiree Health Insurance and Pension Coverage: Variations by Firm Characteristics*, 49 J. GERONTOLOGY S53, S53 (1994) [hereinafter Clark et al., *Retiree Health Insurance*] (“Provisions for the extension of health coverage after retirement were introduced into many employer-sponsored health plans beginning in the late 1960s. The widespread adoption of retiree health plans paralleled the establishment of Medicare. In fact, many plans were developed in close coordination with Medicare.”).

42. JONATHAN OBERLANDER, THE POLITICAL LIFE OF MEDICARE 31 (2003) (“Medicare’s benefits, reimbursement mechanisms, administration, and structure of insurance all reflected prevailing practices in the American private sector [in 1965]. In concrete terms, this meant that Medicare followed the Blue Cross-Blue Shield model of health insurance; . . . and paid physicians and hospitals generously, retrospectively, and with little oversight.”).

Medicare⁴³ but a boon for retiree health plans that paid after Medicare.

In addition to the cost savings realized from piggybacking on Medicare, employers could afford to be generous because the retiree population remained small as compared to active workers. For example, in 1960, every retired worker in the U.S. was supported, statistically, by five active workers.⁴⁴ In 1970, approximately 13.35 million retired workers received Social Security retirement benefits⁴⁵ while ninety-three million workers paid into the system in that year⁴⁶—a ratio of roughly seven active for every one retired worker. Employers also typically paid for retiree health benefits on a year-by-year basis, with no required financial recognition or disclosure of long-term costs.⁴⁷ As long as they were meeting the expenses year by year, employers were comfortable. For unionized employers, retiree health benefits became “virtually a ‘throwaway’ in negotiations”⁴⁸ because employers could make what they perceived as an almost-irrelevant future promise in exchange for a desired current concession from the union.⁴⁹ Some employers also enhanced retiree health benefits

43. *Id.* at 84. Medicare’s financial crises eventually led to significant provider payment reforms in the 1980s. Medicare adopted a system of prospective payment with diagnosis-related groups. Rather than simply reimbursing hospitals whatever costs they incurred treating Medicare patients, the new model would pay hospitals a predetermined set rate based on the patient’s diagnosis. The payment would be unrelated to any specific hospital’s costs. Instead, it would be a national payment based on the average costs of a general hospital.

RICK MAYES & ROBERT A. BERENSON, *MEDICARE PROSPECTIVE PAYMENT & THE SHAPING OF U.S. HEALTH CARE* 31 (2006).

44. Alden Skar, *Talkin’ ‘Bout My Generation: The Challenges and Changes of a Maturing Workforce*, EMP. BENEFIT PLAN REV., Feb. 2007, at 8, 10.

45. Specifically, 13,352,145 retired workers received Social Security retirement benefits in 1970. Social Security Administration, Social Security Beneficiary Statistics, http://www.ssa.gov/OACT/STATS/OA_benies.html (last visited July 8, 2009).

46. In 1970, of the approximately 93,090,000 covered workers (meaning those with earnings subject to Social Security payroll taxes), about 6,270,000 were self-employed. SOCIAL SECURITY ADMINISTRATION, ANNUAL STATISTICAL SUPPLEMENT 4.30 tbl. 4.B11, <http://www.ssa.gov/history/pdf/t4b11.pdf> (last visited July 8, 2009) [hereinafter SSA, ANNUAL STATISTICAL SUPPLEMENT].

47. FAS 106, *supra* note 4, at 167, App. D (noting that when the FASB added “other postemployment benefits” to its project list in 1979, it did so because “[e]vidence suggested that most large employers, as well as many smaller ones, provided health care and life insurance benefits to their retirees and were accounting for those benefits on a pay-as-you-go (cash) basis. Existing accounting pronouncements did not cover postretirement benefits provided outside a pension plan.”).

48. SCHIEBER, *supra* note 34, at 20.

49. U.S. GEN. ACCOUNTING OFF., RETIREE HEALTH PLANS: HEALTH BENEFITS NOT SECURE UNDER EMPLOYER-BASED SYSTEM, REPORT NO. GAO/HRD-93-125, at 1 (1993).

to shrink workforces during the recession years of the 1970s.⁵⁰ Following the passage of the Age Discrimination in Employment Act (“ADEA”) in 1967, employers risked discrimination lawsuits if they terminated older workers.⁵¹ But, providing health insurance to early retirees could induce older workers to leave voluntarily and avoided ADEA concerns. By 1988, about 66% of all private sector employers with 200 or more employees provided retiree health insurance as a core benefit.⁵²

In the public sector, retiree health benefit coverage in the mid-1980s was lower than in the private sector. By 1987 only about 48% of all state and local government retirees under the age of sixty-five (44% of those ages sixty-five or older) participated in retiree health plans.⁵³ Over the next two decades, however, state and local governments increased coverage. By 1997, approximately 62% of local governments offered retiree health benefits to early (pre-Medicare) retirees, and 47% did the same for Medicare-eligible retirees.⁵⁴ State governments covered 76% of pre-Medicare retirees by 1997 and 69% of Medicare-eligible retirees.⁵⁵ Over the next five years, local government coverage slipped to 55% for pre-Medicare retirees and 35% for Medicare-eligible retirees,⁵⁶ but state governments expanded coverage to 92% for pre-Medicare retirees and 86% for Medicare-eligible retirees.⁵⁷ By 2007, an overwhelming 98% of state and larger local government employers reported that they offered retiree healthcare benefits to pre-Medicare retirees, with 81% also offering such benefits to Medicare-eligible retirees.⁵⁸

50. ROLAND D. MCDEVITT ET AL., WATSON WYATT WORLDWIDE, RETIREE HEALTH BENEFITS: TIME TO RESUSCITATE? 2-3 (2002), available at <http://www.americanbenefitscouncil.org/documents/w559.pdf>.

51. Age Discrimination in Employment Act of 1967, Pub. L. No. 90-202, 81 Stat. 602 (1967) (codified as amended at 29 U.S.C. §§ 621-34 (2006)).

52. HENRY J. KAISER FAM. FOUND. & HEWITT ASSOC., RETIREE HEALTH BENEFITS EXAMINED: FINDINGS FROM THE KAISER/HEWITT 2006 SURVEY ON RETIREE HEALTH BENEFITS 1 (2006), <http://www.kff.org/medicare/upload/7587.pdf> [hereinafter KAISER/HEWITT 2006 RETIREE SURVEY].

53. Allan P. Blostin et al., *Disability and Insurance Plans in the Public and Private Sectors*, MONTHLY LAB. REV., Dec. 1988, at 9, 10, available at http://www.bls.gov/opub/mlr/1988/12/art2_full.pdf.

54. Paul Fronstin, *The Impact of the Erosion of Retiree Health Benefits on Workers and Retirees*, EMP. BENEFIT RESEARCH INST., ISSUE BRIEF NO. 279, Mar. 2005, at 5 fig. 2, available at <http://www.ebri.org/pdf/briefspdf/0305ib.pdf>. The survey covered only local governments with 250 to 999 employees. *Id.*

55. *Id.* at fig. 3.

56. *Id.* at fig. 2.

57. *Id.* at fig. 3.

58. HENRY KAISER FAM. FOUND. & HEALTH RESEARCH AND EDUC. TRUST, EMPLOYER HEALTH BENEFITS: 2007 ANNUAL SURVEY 158 ex. 11.5 (2007), available at http://www.kff.org/insurance/7672/sections/upload/7672_Section_1_1.pdf. This survey does not distinguish state from local government employers but covers only employers with at least 200 employees. *Id.*

Exactly why public sector retiree health benefits expanded after the 1980s is unclear. One explanation may lie in the prevailing public employer view that enhanced benefits offer the best way to compete for desirable employees. For example, state and local government employers in 2008 characterized “retiree health care benefits as central to their recruitment, retention, and retirement timing goals . . .”⁵⁹ The increase in retiree benefits may also reflect a reaction to economic stresses in the early 1990s. Public sector employers are generally forced to balance budgets annually, or at least on a biennial basis.⁶⁰ As a result, they have comparatively little flexibility when finances are tight. During the recession years of the early 1990s, state and local government employees faced wage freezes and furlough days as their employers struggled to reduce current expenses and balance budgets.⁶¹ At the same time, however, government employers could increase retiree health benefits without any immediate impact on their financial statements.⁶² The increase in retiree health benefits over the early years of this period may thus constitute a reaction to limits on other areas of employee compensation.⁶³

II. PROBLEMS ARISE WITH RETIREE HEALTH BENEFITS

A perfect storm hit private sector retiree health benefits after the mid-1980s. Healthcare costs overall had skyrocketed since the 1960s.⁶⁴ By the early 1990s, employers were intensely focused on

59. CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, RETIREE HEALTH CARE IN THE AMERICAN STATES 1 (2008), available at <http://www.slge.org>.

60. ACADEMYHEALTH, ROBERT WOOD JOHNSON FOUND., STATE OF THE STATES: CHARTING A COURSE: PREPARING FOR THE FUTURE, LEARNING FROM THE PAST 10 (2009), available at <http://www.statecoverage.org/files/State%20of%20the%20States-2009.pdf>.

61. Michael Cimini et al., *Negotiated Wage Changes in Government, 1992*, MONTHLY LAB. REV., June 1993, at 34, available at <http://www.bls.gov/opub/mlr/1993/06/art4full.pdf>. See also Michael H. Cimini, *Negotiated Changes in State and Local Government Contracts, 1993*, MONTHLY LAB. REV., Aug. 1994, at 3, available at http://www.bls.gov/opub/mlr/1994/08/art1_full.pdf (discussing the impact of a difficult economic climate on public sector collective bargaining agreements).

62. FAS 106 became effective for most private sector employers at the end of 1992, but no accounting rule forced government employer recognition of long-term liability for retiree health benefits before GASB 45 was published in 2004. See FAS 106, *supra* note 4, at 9, and GASB 45, *supra* note 5.

63. The initial expansion of the U.S. employment-based health insurance system may be attributed in part to World War II wage controls, which did not apply to employment-based benefits, implemented during World War II. IOM, *supra* note 6, at 70 (“In a war economy with labor shortages, employer contributions for employee health benefits became a means of maneuvering around wage controls.”).

64. See *supra* note 13 and accompanying text.

finding some way to control their health benefit expenses.⁶⁵ Long gone was the halcyon era when employers worried about pension expenses, not healthcare.⁶⁶ Retiree health benefits offered a natural target because they tended to be more expensive for employers than active employee benefits. One study of large employers in 2004 found that retiree healthcare costs accounted for 29% of their total healthcare expenses in that year.⁶⁷ Older individuals statistically are simply less healthy—and thus, more expensive—than younger persons.⁶⁸ The elderly also have far higher prescription drug costs than younger people,⁶⁹ and Medicare historically provided almost no coverage of outpatient prescription drug costs.⁷⁰ Before the introduction of Medicare Part D prescription drug coverage in 2006, employment-based retiree health plans served as the single largest source of prescription drug coverage for the elderly.⁷¹

65. See Thomas P. Burke & Rita S. Jain, *Trends in Employer-Provided Health Care Benefits*, MONTHLY LAB. REV., Feb. 1991, at 24, available at <http://stats.bls.gov/opub/mlr/1991/02/art3full.pdf> (describing how managed care grew out of employer efforts to control healthcare expenses).

66. See Gordon, *supra* note 11, at lxviii.

67. HENRY J. KAISER FAM. FOUND. & HEWITT ASSOC., CURRENT TRENDS AND FUTURE OUTLOOK FOR RETIREE HEALTH BENEFITS: FINDINGS FROM THE KAISER/HEWITT 2004 SURVEY ON RETIREE HEALTH BENEFITS 1 (2004), <http://www.kff.org/medicare/7194>.

68. See CTRS. FOR DISEASE CONTROL, JAN.-SEPT. 2008 NATIONAL HEALTH INTERVIEW SURVEY, fig. 11.3, (2009), http://www.cdc.gov/nchs/data/nhis/early_release/200903_11.pdf (reporting that, in the 2008 National Health Interview Survey, only 39.3% of individuals age 65 or older reported themselves as in “excellent or very good health” as compared with 82.4% of those under age 18 and 65% of those age 18-64).

69. *The Future of Retiree Health Benefits: Challenges and Options: Hearing Before the Subcomm. on Employer-Employee Relations of the H. Comm. on Educ. & the Workforce*, 106th Cong. ex. 4 (2001) (statement of Patricia Neuman, Vice President & Director, Medicare Poly Project, Henry J. Kaiser Fam. Found.), available at <http://www.kff.org/medicare/6010-index.cfm> (reporting that adults between the ages of 65 and 74 fill approximately four times more prescriptions per year than do adults below the age of 45).

70. Medicare did not offer comprehensive outpatient prescription drug coverage until the implementation of Part D in January 2006. 42 U.S.C. § 1395w-101 (2003). See Jonathan Oberlander, *Through the Looking Glass: The Politics of the Medicare Prescription Drug, Improvement and Modernization Act*, 32 J. HEALTH POL. POLY & L. 187, 188 (Apr. 2007) (detailing the complicated background of Medicare Part D); Thomas R. Oliver et al., *A Political History of Medicare and Prescription Drug Coverage*, 82 MILBANK QUARTERLY 283, 316-17 (2004), available at <http://www.kff.org/medicare/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=42275> (reviewing the treatment of prescription drug coverage in Medicare and the impact of Medicare Part D).

71. A 2003 study reviewing elderly prescription drug coverage before Medicare Part D found that 29% of the elderly obtained prescription drug coverage through employer-sponsored plans. Dana Gelb Safran et al., *Prescription Drug Coverage and Seniors: Findings from a 2003 National*

Increasing healthcare costs in the 1970s and 1980s also affected Medicare, creating a ripple effect among employer plans offering wrap-around coverage for Medicare-eligible retirees. In an effort to rein in Medicare costs, Congress in the 1980s imposed a number of payment reforms that pushed financial risk at least partially onto providers.⁷² Providers responded by shifting their unreimbursed costs to private insurance payors, and the process translated into higher costs for employers⁷³—the primary source of private insurance. This process helped to undercut the financial boost that Medicare had given retiree health benefits in the late 1960s and early 1970s.⁷⁴

Demographic changes with related retiree health cost impact also began to affect employers by the early 1990s because the U.S. population had been steadily aging.⁷⁵ In 1960, only 9.2% of the population was age sixty-five or older; by 1980 that demographic had grown to 11.3%; and by 1990 it had reached 12.6%.⁷⁶ From the mid-1960s through at least the mid-1990s, U.S. employers also experienced a trend of earlier and longer retirements.⁷⁷ Not surprisingly, the ratio of active to retired employees nationwide

Survey, HEALTH AFF. W5-152, W5-160 ex. 4, Apr. 19, 2005, <http://content.healthaffairs.org/cgi/reprint/hlthaff.w5.152v1?ijkey=Gn1EKoVVrGMv.&keytype=ref&siteid=healthaff>. Another 20% purchased private Medicare supplemental or other insurance to obtain coverage. *Id.*

72. The prospective payment system and diagnosis-related groups meant that hospitals, for example, could collect only relatively fixed amounts, no matter how much a particular patient's care actually cost. MOON, *supra* note 40, at 59-65.

73. RICK MAYES & ROBERT A. BERENSON, *supra* note 43, at 73-74.

74. *See supra* notes 38-43 and accompanying text.

75. WAN HE ET AL., U.S. CENSUS BUREAU, 65+ IN THE UNITED STATES: 2005 1 (2005), available at <http://www.census.gov/prod/2006pubs/p23-209.pdf> ("The U.S. older population grew rapidly for most of the 20th century, from 3.1 million in 1900 to 35.0 million in 2000. Except during the 1990s, the growth of the older population outpaced that of the total population and the population under age 65.").

76. *Id.* at 9, tbl. 2-1 (noting that the percentage slipped slightly over the 1990s to 12.4% by 2000). *See also* U.S. Census Bureau, *An Older and More Diverse Nation by Midcentury*, U.S. Census Bureau Newsroom (Aug. 14, 2008), <http://www.census.gov/Press-Release/www/releases/archives/population/012496.html> (explaining that the percentage of older Americans is expected to rise dramatically in the twenty-first century). The press release continues, "In 2030, because all of the baby boomers will be 65 and older, nearly one in five U.S. residents is expected to be 65 and older. *Id.* This age group is projected to increase to 88.5 million in 2050, more than doubling the number in 2008 (38.7 million)." *Id.*

77. Murray Gendell, *Trends in Retirement Age in Four Countries, 1965-95*, MONTHLY LAB. REVIEW, Aug. 1998, at 22-24, available at <http://www.bls.gov/opub/mlr/1998/08/art2full.pdf> (reporting that the length of time American men lived after retirement increased significantly between 1960 and 1990).

shrank from the early 1970s through the next two decades.⁷⁸ For example, the number of retired workers drawing Social Security retirement benefits increased from 13.35 million in 1970 to 25.76 million in 1992.⁷⁹ Over the same years, the number of workers paying into the system increased from about 93 million to about 134 million.⁸⁰ Thus, only slightly more than five active workers (about 5.2) paid into Social Security for every retired worker in 1992 as compared to the 1970 ratio of closer to seven active workers (about 6.97) to one retired worker.⁸¹ For those employers who provided retiree health insurance, these trends meant that more and more aging individuals with potentially expensive health issues were joining the retiree plans at the same time that fewer active workers were boosting the companies' productivity. Beginning in the late 1970s, economic challenges that struck manufacturing industries—those historically with generous benefits—exacerbated the problem.⁸² After about 1980, manufacturing industries steadily shed jobs instead of increasing or even maintaining stable employment figures.⁸³ The numbers could be stark for individual companies. For example, in 1980, 70,000 active employees at Bethlehem Steel supported 54,000 retirees; by 1985, the active workforce had shrunk almost in half—to only 37,000 active workers—while the number of retirees had grown to 70,000.⁸⁴ By the late 1990s, GM reportedly supported 400,000 retirees with only 180,000 active employees.⁸⁵ Then, in the early 1990s, the country moved into another

78. Various explanations have been offered, including the aging U.S. population, increased life expectancy, early retirement trends, and slowed hiring practices. Clark et al, *Retiree Health Insurance*, *supra* note 41, at S53.

79. Specifically, 25,757,727 retired workers received Social Security retirement benefits in 1992. Social Security Administration, *Social Security Beneficiary Statistics*, <http://www.ssa.gov/OACT/STATS/OAbenies.html> (last visited July 8, 2009). By 2008, that number had increased to 32,273,145 retired workers receiving Social Security retirement benefits. *Id.*

80. SSA, ANNUAL STATISTICAL SUPPLEMENT, *supra* note 46, at Table 4.B11. The numbers have continued to increase. *Id.* In 2005, 159,703,000 workers—including more than 16 million self-employed individuals—were paying into the Social Security system. *Id.*

81. The active-to-retired worker ratio is expected to drop considerably more in the future. Some projections indicate that by 2030 there will be only two active workers for every retiree. Skar, *supra* note 44, at 10.

82. Ronald E. Kutscher, *Historical Trends, 1950-92, and Current Uncertainties*, MONTHLY LAB. REV., Nov. 1993, at 3, 5-6, available at <http://www.bls.gov/opub/mlr/1993/11/art1full.pdf>.

83. *Id.* at 6 (stating that manufacturing employment “peaked” in 1979 at about 21,040,000 jobs, but had dropped to about 18,040,000 jobs by 1992). In 1950, manufacturing industries employed almost 34% of all American workers; by 1992 they had dropped to only about 16.6% of the non-farm workforce. *Id.*

84. QUADAGNO, *supra* note 6, at 149.

85. Jeff Madrick, *Empty Nest Egg*, N.Y. TIMES, May 4, 2008, at BR 6.

recession, with another 600,000 manufacturing job losses (among other signs of economic downturn).⁸⁶

Despite increasing healthcare costs, challenging demographics, and a faltering economy, private sector employers might have muddled along well into the 1990s by implementing various strategies to curb retiree benefit expenses just as they were doing with active employee health plans.⁸⁷ After all, they were funding both on a pay-as-you-go basis. As long as they could meet their annual benefit expenses, employers might have continued to let long-term future retiree health commitments build up for the sake of current employee goodwill. But that was not to be. Instead, a day of reckoning arrived for private sector retiree health plans in the unlikely form of an accounting rule. FAS 106 became effective for most companies in late 1992 and required affected companies to include in current financial statements the expected cost of future retiree health benefit commitments.⁸⁸ Although FAS 106 did not actually increase obligations, it forced recognition of the true cost of past promises.⁸⁹ The accumulating liabilities turned out to be enormous. As early as 1986, some estimates pegged the retiree health liabilities of the Fortune 500 at approximately \$2 trillion when assets of those companies totaled only about \$1.3 trillion.⁹⁰ Recognizing the accumulated cost of those eventual commitments torpedoed corporate balance sheets. Ford took a \$7.5 billion charge in one year; GM estimated in 1992 that it would have to account for between \$16 billion to \$24 billion to reflect its accrued postretirement health benefit

86. Christopher J. Singleton, *Industry Employment and the 1990-01 Recession*, MONTHLY LAB. REV., July 1993, at 15, 20, available at <http://www.bls.gov/opub/mlr/1993/07/art2full.pdf>.

87. See Burke & Jain, *supra* note 65 and accompanying text.

88. FAS 106, *supra* note 4, at 4. See also FASB, *Summary of Statement No. 106: Employers' Accounting for Postretirement Benefits Other Than Pensions* (1990), <http://www.fasb.org/st/summary/stsum106.shtml> (“[A]lthough it applies to all forms of postretirement benefits, this Statement focuses principally on postretirement health care benefits.”). The Summary continues, “It will significantly change the prevalent current practice of accounting for postretirement benefits on a pay-as-you-go (cash) basis by requiring accrual, during the years that the employee renders the necessary service, of the expected cost of providing those benefits to an employee and the employee’s beneficiaries and covered dependents.” *Id.*

89. Admittedly, FAS 106 could be viewed simply as “a formal acknowledgment of obligations that were always there.” Milt Freudenheim, *Banks Look Hard at Cost of Benefits*, N.Y. TIMES, Nov. 24, 1992, at D2. One banker, discussing the impact of FAS 106 on the auto companies, noted that the banks had “a ‘high awareness’ for years of the auto companies’ promises, made long ago in union contracts, which were not reflected on financial statements.” *Id.*

90. Pat Widder, *Benefit Deals Face Retirement; Navistar Neither First Nor Last to Cut*, CHICAGO TRIB., Aug. 30, 1992, at C1.

liability.⁹¹ At the time, overall FAS 106 disclosure was expected to drop corporate earnings of the Fortune 500 by 15 to 20% in the first year.⁹²

More than a decade passed before GASB—the public sector equivalent of the Financial Accounting Standards Board—in 2004 issued Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.⁹³ The Statement effectively paralleled the reporting requirements imposed on private employers by FAS 106.⁹⁴ GASB 45 pushes state and local governments to adopt the same approach private sector public companies follow: reflecting unfunded accrued liabilities for retiree health and welfare benefits (often called “other postemployment benefits” or “OPEB”) in current financial reports. GASB noted that government financial statements were incomplete because “most governments report their cash outlays for OPEB in a given year, rather than the cost to the employer of OPEB earned by employees in that year,” and because the two figures “may be vastly different.”⁹⁵ As with FAS 106, the GASB standards do not “mandate the funding of OPEB benefits,”⁹⁶ but they do require accurate reporting of the present value of future benefit promises.⁹⁷ Nonetheless, GASB 45 has spawned tremendous focus on the looming financial risk of retiree medical benefit liabilities for both state and local governments.⁹⁸

As with private sector retiree health costs in the early 1990s, the public sector accumulated massive liability for these benefits.

91. Milt Freudenheim, *Companies Reducing Benefits Promised for Their Retirees*, N.Y. TIMES, Dec. 24, 1992, at A1.

92. Widder, *supra* note 90, at C1.

93. GASB 45, *supra* note 5. GASB also issued GASB, STATEMENT NO. 43, FINANCIAL REPORTING FOR POSTEMPLOYMENT BENEFITS OTHER THAN PENSIONS, in 2004 to require similar reporting for trusts and other conduits used to prefund benefits. *Id.*

94. GASB 45, *supra* note 5.

95. GASB, OTHER POSTEMPLOYMENT BENEFITS: A PLAIN-LANGUAGE SUMMARY OF GASB STATEMENTS NO. 43 AND NO. 45 1 (2004), available at http://www.Gasb.org/project_pages/opeb_summary.pdf [hereinafter GASB PLAIN-LANGUAGE SUMMARY].

96. *Id.* at 9.

97. See GASB, STATEMENT NO. 45 ON OPEB ACCOUNTING BY GOV'TS: A FEW BASIC QUESTIONS AND ANSWERS (2004) (stating that “[s]tatement 45 was issued to provide more complete, reliable and decision-useful financial reporting regarding the costs and financial obligations that governments incur when they provide postemployment benefits other than pensions (OPEB) as part of the compensation for services rendered by their employees.”).

98. See CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, BALANCING DOLLARS AND HEALTH SENSE: A FRAMEWORK FOR DECISION MAKING ON FUNDING STATE RETIREE HEALTH CARE BENEFITS, June 2008, <http://www.slge.org/vertical/Sites/%7BA2601E1DF-5AEE-4590-84C4-876EFE1E4032%7D/uploads/%785D473689-13FB-4EB2-BC23-0FD5BBC1D49E%7D.pdf>.

Taken as a group, state and local governments face unfunded retiree health costs estimated between \$600 million and \$1.6 trillion.⁹⁹ For some employers, these liabilities could consume much of their annual budgets. Duluth, Minnesota, for example, has computed its GASB 45 liability to be more than double the city budget, and the Los Angeles school district has calculated its liability at approximately 80% of its annual budget.¹⁰⁰ Like many private employers, most state and local governments apparently failed to consider the long-term financial consequences of their retiree medical benefit commitments.¹⁰¹ Most public sector employers have funded these benefits on a pay-as-you-go basis,¹⁰² appropriating funds each year for that year's benefit expenses alone.¹⁰³ Only a few employers have set aside assets to cover future medical expenses.¹⁰⁴

99. U.S. GOV'T ACCOUNTABILITY OFFICE, STATE & LOCAL GOV'T RETIREE BENEFITS: CURRENT FUNDED STATUS OF PENSION AND HEALTH BENEFITS, REPORT NO. GAO-08-223 3 (2008); see also PEW CTR. ON THE STATES, PROMISES WITH A PRICE: PUBLIC SECTOR RETIREMENT BENEFITS 7, 41, 45 (2007), available at <http://www.pewcenteronthestates.org/uploadedfiles/Promises%20with%20a%20Price.pdf> (pegging the unfunded cost of retiree health care and other non-pension benefit obligations at about \$370 billion at the end of the 2006 fiscal year). The liabilities appear to rest with state and larger local governments as one 2008 survey determined that most small governments—those serving populations of 5000 or less—have few employees and rarely offer any form of health benefits, much less retiree benefits. *Study Examines Local Governments' Responses to Health-Care Costs, GASB 45, 24 GOV'T. FIN. REV.* 4 (2008).

100. Samuel H. Fleet, *Cities and Counties Feeling Pressure on Reporting Retiree Health Benefits*, NATIONAL UNDERWRITER, Mar. 19, 2007, available at http://www.lifeandhealthinsurancenews.com/Issues/2007/11/Pages/Cities-And-Counties-Feeling-Pressure-On-ReportingRetiree_Health_Benefits.aspx?k=Cities+and+Counties+Feeling+Pressure.

101. The executive director of the Chicago Transit Authority's pension fund, which has been funding retiree health care since 1980, observed in late 2006, that "[t]here were decisions taken years ago that seemed harmless at the time, but now they're very problematic." Mary Williams Walsh, *Paying Health Care from Pension Proves Costly*, N.Y. TIMES, Dec. 19, 2006, at A1. Even with GASB 45 looming, public sector employers did not move quickly to respond; the magnitude of the liabilities "induced near paralysis among policymakers and administrators across the nation as GASB 45 has kicked in and brought retiree health care costs out of the basement, where public employers have kept them buried for years." Samuel H. Fleet, *GASB 45 Words of Wisdom: Don't Just Stand There—Do Something!*, EMP. BENEFITS PLAN REV. 18, 18 (2007).

102. According to GASB, most state and local governments "pay . . . an amount each year equal to the benefits distributed or claimed in that year." GASB PLAIN-LANGUAGE SUMMARY, *supra* note 95.

103. J. RALPH CROSS, UNIV. OF TENN. MUNICIPAL TECHNICAL ADVISORY SERVICE, GASB STATEMENT NO. 45 (2007), available at <http://www.mtas.tennessee.edu/knowledgebase.nsf/printerfriendlyproductweb?openform&parentUNID=D46F003F45A5C16A852572C00042F614>.

104. At the end of fiscal year 2006, only six states (Arizona, North Dakota,

Growing economic woes have accelerated the challenge for government employers. As of July 2009, more than forty-five states reported “revenue shortfalls of about \$40 billion.”¹⁰⁵ Because of legal obligations to balance their budgets,¹⁰⁶ state and local governments typically “must close budget gaps by cutting expenditures, raising tax revenues, or drawing from rainy day funds or reserves.”¹⁰⁷ State and local governments often borrow to meet many of their immediate obligations, and their borrowing costs depend heavily upon their credit ratings. With credit rating agencies reported to be paying close attention to GASB 45 reporting,¹⁰⁸ public sector employers are necessarily concerned about the impact of retiree health liabilities on their future borrowing ability.¹⁰⁹

Ohio, Oregon, Utah, and Wisconsin) were on target to fund their promised retiree health and other welfare benefits fully over the next thirty years, but only Alaska, Arizona and Wisconsin had “funded more than 50 percent of their actuarial liability.” PEW CTR. ON THE STATES, *supra* note 99, at 7, 43. None of the five largest states—California, Texas, New York, Florida and Illinois—had done any pre-funding whatever. *Id.* at 43. The Pew study found that at least thirteen states had established trusts of some kind in order to pre-fund the benefits. *Id.* at 7. Some public sector employers directed pension fund surpluses in the 1980s to year-by-year retiree health costs, a strategy that is permitted under the Code but is not without its own risks. 26 U.S.C. § 420 (2006); see Walsh, *supra* note 101, at A1 (noting that this tactic can have a deleterious impact because it reduces the excess assets available to fund future pension benefits).

105. National Conference of State Legislatures, *supra* note 15 (noting that the financial challenge “places pressure on health benefit programs to seek fiscal savings”).

106. ACADEMYHEALTH, *supra* note 60, at 9-10.

107. *Id.* at 10.

108. See, e.g., Gov’t Finance Review, *Fitch Ratings Weighs in on Credit Implications of GASB 45*, 24 GOV’T. FIN. REV. 21, 21 (2005) [hereinafter *Fitch Ratings Weighs in*] (quoting a report from Fitch that stated, “Fitch Ratings views GASB 45 as a positive step toward more fully illuminating governmental obligations to retirees” and also “over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer’s credit rating.”). See also Parry Young, *Funding OPEB Liabilities*, 21 GOV’T. FIN. REV. 10, 14 (2005) (providing Standard & Poor’s view that “[i]f any changes resulting from OPEB have the effect of adversely affecting an employer’s financial position or flexibility, then credit quality may suffer.”).

109. See PAULA SANFORD, NAT’L CTR. FOR STUDIES OF COUNTIES, IMPLEMENTATION OF GASB 45: CASE STUDIES OF 15 COUNTIES 24 (2007), available at <http://www.naco.org/Content/ContentGroups/Special/sp-2007-12-10-GASB-45.pdf> (explaining that credit-rating agencies “[p]rovide opinions on the credit worthiness of state and local governments to lenders who use this information to determine whether and at what interest rate they will loan money (e.g., buy bonds . . .) to governments.”). In addition, “for many governments, a high credit rating is [a] source of pride because it reflects the fiscal health and management practice of the organization.” *Id.*

III. EMPLOYER RESPONSES TO RETIREE HEALTH BENEFIT LIABILITIES

FAS 106 proved the last straw for many private employers' retiree health commitments¹¹⁰ as many companies chose to terminate retiree health plans.¹¹¹ Between 1988 and 1991 alone, as FAS 106 loomed, the number of large companies offering retiree health benefits dropped by 20%.¹¹² By 2006, only 38% of large employers still offered retiree health plans.¹¹³ At first, employers faced litigation and questions as to their right to terminate retiree health plans,¹¹⁴ but over time it became clear that perceived lifetime retiree health benefit "guarantees" were far less secure than most retirees imagined.¹¹⁵ The one exception proved to be collectively bargained plans, where unions could continue to insist on preserving the retiree benefits. Although even unionized retirees have found retiree health benefits less stable than they expected,¹¹⁶ clearly the presence of a union tends to improve the chances of ongoing retiree health insurance. Despite the overall decline in retiree health insurance,¹¹⁷ 86% of collectively bargained employers, large and small, continued to offer retiree health benefits in 2006.¹¹⁸

Unionized or not, most surviving retiree health plans tried to control costs by imposing cost-sharing obligations on retirees. For

110. Anna M. Rappaport, *FAS 106 and Strategies for Managing Retiree Health Benefits*, 17 COMPENSATION & BENEFITS MGMT. 37, 37 (2001).

111. See Freudenheim, *supra* note 91, at A1 (asserting that "[a]t least 23 large companies have abandoned the health benefits that they were providing to thousands of retired employees. Dozens more have announced that they will not provide coverage for future retirees, and most employers who still offer the benefits are reducing their share of the costs, which have been climbing steeply.").

112. HENRY J. KAISER FAM. FOUND. & HEWITT ASSOC., EMPLOYER HEALTH BENEFITS: 2003 ANNUAL SURVEY ex. 11.1 (2003), <http://www.kff.org/insurance/ehbs2003-13-chart.cfm#1>.

113. KAISER/HEWITT 2006 RETIREE SURVEY, *supra* note 52, at 5.

114. Clark at al., *Retiree Health Insurance*, *supra* note 41, at S53.

115. See generally Donald T. Weckstein, *The Problematic Provision and Protection of Health and Welfare Benefits for Retirees*, 24 SAN DIEGO L. REV. 101 (1987); Steven J. Sacher, *Retiree Health Benefit Cutbacks: Issueman Attempts to Untangle the Web*, 20 BNA PENSION & BENEFITS REP. 1242 (1993); Larry Grudzien, *The Great Vanishing Benefit, Employer Provided Retiree Medical Benefits: The Problem and Possible Solutions*, 39 J. MARSHALL L. REV. 785 (2006); David A. Pratt, *The Past, Present and Future of Retiree Health Benefits*, 3 J. HEALTH & BIOMEDICAL L. 103 (2007); Richard L. Kaplan et al., *Retirees at Risk: The Precarious Promise of Post-Employment Health Benefits*, 9 YALE J. HEALTH POL'Y, L. & ETHICS 287 (2009).

116. William T. Payne & Pamela Ewing, *Union-Negotiated Lifetime Retiree Health Benefits: Promise or Illusion*, 9 MARQUETTE ELDER'S ADVISOR 319, 356 (2008).

117. See *supra* notes 111-113 and accompanying text.

118. KAISER/HEWITT 2006 RETIREE SURVEY, *supra* note 52, at 3.

example, a 2006 survey found that 81% of employers imposed deductibles and 91% required retiree premium contributions.¹¹⁹ Employers sometimes tightened eligibility provisions, requiring older ages and longer periods of service to qualify for benefits.¹²⁰ Many employers adopted caps on total retiree health expenses,¹²¹ often in direct reaction to FAS 106.¹²² For example, in 1992, Caterpillar, Inc. announced that it would begin capping retiree health benefits in 2000 at whatever the 1999 cost turned out to be and would shift any additional costs to retirees by imposing premiums.¹²³ Similarly, Detroit Diesel announced a cap on its retiree health insurance contributions in the early 1990s in response to FAS 106.¹²⁴

Employers also responded to rising costs by adopting defeasance VEBA models, sometimes in conjunction with caps. A defeasance VEBA allows an employer to reach an agreement with the applicable union to fund a stand-alone, tax-exempt trust that assumes full responsibility for all future retiree health benefits.¹²⁵ Once the trust is funded as agreed, the employer is released from liability. An independent board of trustees, answerable ultimately to retirees, runs the trust and manages an independent health plan the trust establishes to provide the requisite retiree health benefits. Defeasance VEBAs have appeared only with unionized private sector employers because non-unionized private sector employers generally can terminate retiree health benefits they cannot afford¹²⁶ and because the Code provides tax advantages for collectively bargained VEBAs that are not available to other VEBAs.¹²⁷ However, even collectively bargained private sector employees have little reason to agree to a defeasance VEBA unless

119. *Id.* at 7 (regarding deductibles), 16 (regarding premiums).

120. *Id.* at 20.

121. Of the large firms surveyed in 2006, half had placed a cap on their contributions to retiree health benefits in their largest plan for Medicare-eligible retirees, and 61% of the surveyed employers with a cap had already reached that cap. *Id.* at 13, 14.

122. *Id.* at 13.

123. Plaintiffs' First Amended Complaint, *Winnett v. Caterpillar*, No. 3:06-CV-0235, 2006 WL 5328387 (M.D. Tenn. Sept. 5, 2006). Eventually, Caterpillar agreed with its union to establish a defeasance VEBA to assist with costs above the cap. *See infra* notes 192-195 and accompanying text.

124. *Wood v. Detroit Diesel Corp.*, No. 05-74106, 2005 WL 3579169, at *8 (E.D. Mich. Dec. 30, 2005).

125. Aaron Bernstein, Labor and Worklife Program, Harvard Law School, *Can VEBAs Alleviate Retiree Health Care Problems?*, CAPITAL MATTERS, Apr. 2006, at 7.

126. *See* Ellen O'Brien, AARP Public Policy Inst., *What Do the New Auto Industry VEBA's Mean for Current and Future Retirees?*, INSIGHT ON THE ISSUES, Mar. 2008, at 2 (noting that employers can change benefits any time in the absence of a firm contract with employees).

127. *See infra* notes 179-186 and accompanying text.

financial considerations otherwise make long-term preservation of bargained-for benefits unlikely.¹²⁸ For this reason, defeasance VEBAs have appeared in the private sector exclusively in the context of struggling—usually failing—industries.¹²⁹

Because GASB 45 is so new,¹³⁰ it remains unclear what path the public sector will take.¹³¹ One expert phrased the dilemma for states as follows: “You can put money aside to fund benefits or you can change benefits so as to reduce future costs.”¹³² GASB 45 provides an incentive for funding by permitting use of a higher discount (interest) rate in computing total OPEB liability for funded benefits,¹³³ but funding poses practical problems for government employers.¹³⁴ If a government does choose to fund retiree health benefits, it can take several tax-advantaged routes.¹³⁵ Funding a traditional VEBA will allow assets to

128. See *infra* notes 253-259 and accompanying text.

129. See *infra* Section IV.B.

130. The GASB requirements phased in over a three-year period beginning in 2006. GASB PLAIN-LANGUAGE SUMMARY, *supra* note 95, at 11. Larger governmental entities, with total annual revenues in excess of \$100 million, were required to comply beginning December 15, 2006, while smaller government entities, with total annual revenues under \$10 million, were required to comply beginning after December 15, 2008. *Id.*

131. See Fleet, *GASB 45 Words of Wisdom*, *supra* note 101, at 19 (outlining a number of possible options). See also Young, *Funding OPEB Liabilities*, *supra* note 108 (detailing Standard & Poor's rating agency's analysis of options). Texas has taken an aggressive position against GASB 45, arguing that it has the right to terminate or curtail retiree health benefits as it chooses and thus has no liability for future benefits. John E. Petersen, *Lassoing GASB 45*, GOVERNING, May 1, 2007, <http://www.governing.com/column/lassoing-gasb-45>. Texas has gone as far as proposing legislation to block implementation of the rule. H.D. 2365, 80th Leg., Reg. Sess. (Tex. 2007), available at <http://www.legis.state.tx.us/tlodocs/80R/billtext/pdf/HB02365I.pdf>; Robert Elder, *Texas Revolts Against Benefits Reporting Rule*, Austin American-Statesman, Mar. 8, 2007, available at <http://www.statesman.com/search/content/region/legislature/stories/03/08/8govaccount.html>.

132. PEW CTR. ON THE STATES, *supra* note 99, at 48. A Credit Suisse analysis of the issue concluded that, “[w]hen you get down to it, there are only two simple options: (1) shrink the obligation and/or (2) set aside more assets. Maybe there is another option: A state or local government could simply bury its head in the sand, ignoring the entire matter (probably not the most prudent path).” DAVID ZION & AMIT VARSHNEY, CREDIT SUISSE, YOU DROPPED A BOMB ON ME, GASB: UNCOVERING \$1.5 TRILLION IN HIDDEN OPEB LIABILITIES FOR STATE AND LOCAL GOVTS’ 16 (2007).

133. J.P. MORGAN ASSET MANAGEMENT, THE OPEB CHALLENGE: MAPPING A COMPREHENSIVE STRATEGY FOR PUBLIC EMPLOYERS 6, 13 (2008).

134. *Id.* at 13.

135. See Segal Company, *In Search of OPEB Remedies: Good Medicine Includes Managing Retiree Health Care Costs*, BENEFITS, COMPENSATION AND HR CONSULTING, PUBLIC SECTOR LETTER, Nov. 2007, at 1-2, available at <http://www.segalco.com/uploads/7c77fbb8edf050f30056d819047dd1d4.pdf> (discussing the various trust and other options available to government employers).

accumulate, tax-free and protected from other government budgeting needs, for future healthcare costs; employees and retirees are not taxed on either contributions to or payments from a VEBA for health benefits.¹³⁶ In addition to traditional VEBAs, government employers can establish so-called “115 trusts”—grantor trusts established by governments for a variety of purposes that can include funding benefits.¹³⁷ Because Code Section 115 exempts any income accruing to any governmental entity or derived from the “exercise of any essential government functions” from federal income tax,¹³⁸ 115 trusts enjoy the same tax benefits as VEBAs without the VEBA restrictions. Public sector employers may also establish a medical subaccount, referred to as a “Section 401(h) account,” within a qualified pension plan to fund retiree health benefits.¹³⁹ None of these pre-funding options has been popular to date. For example, in one survey of state plans, 48% said they were “unlikely to adopt,” and 36% said they were “very unlikely to adopt,” a VEBA.¹⁴⁰

Thus far, most states appear unwilling to take the path of the private sector and start cutting benefits. For example, 72% of state plan administrators reported that it was “very unlikely” that their state would “[i]ntroduce a plan that will terminate health care for future retirees” in the next five years, and 76% reported that it was “very unlikely” that their state would “[t]erminate all subsidies for current retirees.”¹⁴¹ Even if they wanted to reduce benefits, state and local government employers are heavily unionized,¹⁴² with benefit protections subject to collective bargaining. Some states even have statutory or constitutional prohibitions that appear to prevent cutback or termination of

136. See *infra* notes 161-162 and accompanying text.

137. 26 U.S.C. § 115 (2006).

138. Code Section 115 provides that “gross income” for purposes of the Internal Revenue Code does not include either “(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia” or “(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.” 26 U.S.C. § 115 (2006).

139. 26 U.S.C. § 401(h) (2006).

140. CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, *supra* note 59, at 6, tbl. 5. Similarly, 48% said they were “unlikely to adopt,” and 32% said they were “very unlikely to adopt,” a 401(h) account. States were somewhat more positive about 115 trusts, with 28% reporting that they were “likely to adopt” such a pre-funding option, but another 32% still reported they were “unlikely to adopt” such a trust and 20% reported themselves as “very unlikely to adopt.” *Id.*

141. *Id.* at 7, tbl. 7.

142. Union membership in the public sector in 2008 was 36.8% as compared to only 7.6% in the private sector. Press Release, U.S. Dept. of Labor, *Union Members in 2008*, (Jan. 28, 2009), available at <http://www.bls.gov/news.release/pdf/union2.pdf>.

retiree health benefits for state employees.¹⁴³ For example, a 2006 survey of state and local government retiree health plans found that 62% of the surveyed employers were limited in making changes due to statutory or regulatory provisions, 25% were subject to collective bargaining agreements, and another 17% cited other factors constraining their flexibility.¹⁴⁴

The states have not been immune to cost containment, however. In a survey administered between late 2007 and early 2008, 66% of state retiree health plans in the past five years had increased both retiree contributions to premiums and retiree co-payments for prescription drugs, 68% had increased dependent premium contributions, 56% had increased retiree co-payments, and 46% had increased deductibles.¹⁴⁵ States are also pursuing a wide range of other cost-management techniques,¹⁴⁶ including defined contribution or consumer-directed health plans.¹⁴⁷

One additional option for state and local governments is issuing debt in the form of OPEB funding bonds to raise money specifically to pay for retiree health benefits.¹⁴⁸ Although seen as a sensible approach by some, this alternative depends on adequate investment of the proceeds and carries its own set of risks.¹⁴⁹ Many governments have issued bonds to cover retiree pension benefits, but those benefits are fixed in amount in a way

143. U.S. GOV'T ACCOUNTABILITY OFFICE, STATE & LOCAL GOV'T RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS, REPORT NO. GAO-07-1156 18 (2007). See generally John Sanchez, *The Vesting, Modification, and Financing of Public Retiree Health Benefits in Light of New Accounting Rules*, 41 J. MARSHALL L. REV. 1147 (2008) (discussing various restraints on modification of public retiree health benefits). There is some doubt as to whether legal restraints on benefit modification or termination are as effective as sometimes perceived. See Kaplan, *supra* note 115, at 302-04.

144. Segal Company, *Results of the Segal Medicare Part D Survey of Public Sector Plans*, SURVEY, Summer 2006, at 3, available at <http://www.segalco.com/uploads/c3880a0050db71d5f61fde95c07d8541.pdf>.

145. CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, *supra* note 59, at 9, tbl. 11.

146. National Conference of State Legislatures, *supra* note 15.

147. Options for cost management also include caps on total employer contributions, changing eligibility requirements and revising coordination with Medicare. J.P. MORGAN ASSET MANAGEMENT, *supra* note 133, at 29. North Carolina, for example, raised service requirements from five to twenty years for an employee to vest in retiree health benefits. Jonathan Walters, *Paying for Promises*, 20 GOVERNING 32, 32 (2007).

148. Wisconsin issued a bond in 2005 to help finance its retiree health benefits. Walters, *supra* note 147, at 32 (quoting Parry Young, head of public finance for Standard & Poor's rating agency, saying: "What we're looking for is a thoughtful plan on how they're going to manage this liability.").

149. See *Fitch Ratings Weigh in*, *supra* note 108, at 1 (stating that "failure to follow balanced and prudent investment practices could expose the plan sponsor to market losses").

healthcare benefits are not.¹⁵⁰ Moreover, if investment returns lag the rate of interest due on the bonds—a scenario easily imagined in light of the 2008–2009 financial climate—a government could find itself not only losing money on an OPEB bond, but also failing to meet increasing retiree health costs.¹⁵¹

IV. VEBAS, TRADITIONAL AND OTHERWISE

A. *Background on VEBAs*

Although not called VEBAs at the outset, employment-based associations organized as early as the mid-1800s to provide financial assistance for workers in times of illness or injury.¹⁵² By the early part of the 1900s, such organizations covered significant portions of the working population.¹⁵³ Although often supported by employers in various ways,¹⁵⁴ a hallmark of these VEBA predecessors was the level of employee control; typically, employees administered and largely funded the associations themselves.¹⁵⁵ So popular were these associations that, when a tax court ruling threatened to treat them as taxable entities,¹⁵⁶ Congress promptly responded by creating VEBAs as a separate type of tax-exempt trust under the Code.¹⁵⁷

150. ERIC S. BERMAN & ELIZABETH K. KEATING, PIONEER INST. FOR PUBLIC POLICY RESEARCH, THE ELEPHANT IN THE ROOM: UNFUNDED PUBLIC EMPLOYEE HEALTH CARE BENEFITS AND GASB 45 19-20 (2006), available at http://www.pioneerinstitute.org/pdf/06_gasb_45_elephant_in_the_room.pdf (noting a long list of concerns with OPEB bonds and citing a Barron's report that concluded "[r]etiree health-care bonds could be very risky for the issuer. States issuing the bonds might have to pay higher rates on subsequent bond issues for bridges, roads and schools—even if their ratings are unaffected by the new debt—simply to attract more buyers.").

151. *Id.* at 20-21 ("[T]he investment return may, in some years, be less than the cost increases of health care, thereby *increasing* its OPEB costs during a period of economic weakness."). Some public entities also may not have authority to issue such bonds. *Id.* at 19.

152. Such organizations are sometimes referred to as "industrial sickness funds." See John E. Murray, *Industrial Sickness Funds, US*, EH NET ENCYCLOPEDIA, June 5, 2008, <http://eh/net/encyclopedia/article/murray.industrial.sickness> (explaining that "industrial sickness funds" were used to describe "funds organized by companies . . . and by labor unions.").

153. Professor Murray notes that industrial sickness funds, along with charitable groups known as fraternal associations, "covered 30 to 40 percent of non-agricultural wage workers in the more industrialized states" by World War I. *Id.*

154. See Paul Tharp, *GM's \$nazy New Model: VEBA*, N.Y. POST, Sept. 27, 2007, at 91 (stating that "VEBAs were created as tax shelters for giant coal and steel companies at the turn of the century to help pay for worker injuries and widows' benefits").

155. IOM, *supra* note 6, at 51-53.

156. Philadelphia & Reading Relief Ass'n, 4 B.T.A. 713, 715 (1926).

157. Revenue Act of 1928, Pub. L. No. 70-562, 45 Stat. 791, 814.

Although the legislative history is quite limited, the section was

Today's Code definition of a VEBA remains virtually identical to its 1928 counterpart: "[v]oluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents"¹⁵⁸ A VEBA is only one type of organization¹⁵⁹ exempt from federal income tax under Code Section 501(a),¹⁶⁰ but it is particularly useful because it permits the accumulation of assets on a tax-exempt basis—with comparatively little regulation—to pay for various types of welfare benefits. When a VEBA provides health benefits, the same tax advantages for beneficiaries apply as with other employment-based health plans. Thus, Code Section 105 excludes from a beneficiary's income any payments from a VEBA for accident or health benefits,¹⁶¹ and Code Section 106 similarly excludes from a beneficiary's income any employer contributions to the VEBA.¹⁶²

Most VEBA rules appear in the underlying Treasury Regulations. The Regulations specify the key qualifications for any VEBA: that there must be an "association of employees" whose membership in the VEBA is "voluntary; that the VEBA must exist only to pay for approved types of benefits; and that "no part of its net earnings may inure to the benefit of any private shareholder or individual except in the form of the permissible benefit payments."¹⁶³ The Regulations further explain that the phrase "sick and accident benefits" means "amounts furnished to or on behalf of a member or a member's dependents in the event of

apparently designed to save employee relief associations from tax after the courts had held in various cases that they could not qualify under various other provisions as local associations of employees or fraternal beneficiary organizations or benevolent life insurance companies.

I.R.S. Gen. Couns. Mem. 37,942 (Apr. 27, 1979).

158. 26 U.S.C. § 501(c)(9) (2006). In the current version of the VEBA definition, the phrase "or designated beneficiaries" follows after "dependents," but the language otherwise mirrors the 1928 wording. *See* Revenue Act of 1928, Pub. L. No. 70-562, 45 Stat. 791, 814. From 1939 until 1969, the Code contained a counterpart to Code Section 501(c)(9) for VEBAs for "individuals who are officers or employees of the United States Government . . ." *See* Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 702; Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 580-1 (1969).

159. Governing Treasury Regulations require that a VEBA exists as a legal entity "independent of the member-employees or their employer." Treas. Reg. § 1.501(c)(9)-2(c)(1) (1981). VEBAs today usually take the form of a trust. *See* 29 U.S.C. § 1103(a) (2006); DAVID S. DUNKLE, VEBAS AND OTHER SELF-INSURED ARRANGEMENTS, 395-2ND, TAX MGMT. PORTFOLIOS IV.C.5 (1993).

160. 26 U.S.C. §§ 501(a), 501(c)(1)-(28) (2006).

161. 26 U.S.C. § 105(b) (2006). *See* I.R.S. Priv. Ltr. Rul. 78-03-024 (Oct. 19, 1977) (determining that health benefits paid to the employees are not included in the employees' gross income).

162. 26 U.S.C. § 106(a) (2006). *See* I.R.S. Priv. Ltr. Rul. 78-03-024 (Oct. 19, 1977).

163. Treas. Reg. § 1.501(c)(9)-1(a)-(d) (1981).

illness or personal injury to a member or dependent.”¹⁶⁴ Preventive care payments “designed to safeguard or improve the health of members and their dependents” also qualify as “sick and accident benefits.”¹⁶⁵ A VEBA may provide the benefits either through direct reimbursement to an individual “for amounts expended because of illness or personal injury, or through the payment of premiums to a medical benefit or health insurance program.”¹⁶⁶

The Regulations also require that a VEBA be “controlled (i) [b]y its membership, (ii) [b]y independent trustee(s) . . . or (iii) [b]y trustees or other fiduciaries at least some of whom are designated by, or on behalf of, the membership.”¹⁶⁷ Any VEBA that also qualifies as an “employee welfare benefit plan” under the Employee Retirement Income Security Act (“ERISA”)¹⁶⁸ and is subject to ERISA’s rules, including fiduciary restrictions, is deemed to qualify as “controlled” by independent trustees.¹⁶⁹ The typical VEBA combines a tax-exempt trust with an employer-sponsored, employer-managed health benefit plan, with some combination of employer and employee funds deposited into the VEBA trust each year to pay for healthcare expenses for plan beneficiaries. The employer sponsoring the related health benefit

164. Treas. Reg. § 1.501(c)(9)-3(c) (1981).

165. *Id.*

166. *Id.*

167. Treas. Reg. § 1.501(c)(9)-2(c)(3)(i)-(iii) (1981). As an example of sufficient “control by or on behalf of the membership,” the Regulations describe a trust created to fund a health insurance benefit plan established pursuant to a collective bargaining agreement between a labor union and an employer. Treas. Reg. § 1.501(c)(9)-2(c)(3)(iii) (1981). In that example, some of the trustees are appointed by the union and some by the employer. Treas. Reg. § 1.501(c)(9)-2(c)(4) ex. 1 (1981). According to the example, the benefit plan agreement and trust “together create a voluntary employees’ beneficiary association over which the employees possess the requisite control through the trustees designated by their representative [union].” *Id.*

168. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (2006)) (“ERISA”). ERISA defines an “employee welfare benefit plan” as

any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 186(c) of this title (other than pensions on retirement or death, and insurance to provide such pensions).

29 U.S.C. § 1002(1) (2006).

169. Treas. Reg. § 1.501(c)(9)-2(c)(3) (1981).

plan controls the details of the health plan. Thus, the employer-sponsor determines what will be covered and how much, establishes annual premiums and deductibles, and typically shoulders a significant percentage of the overall cost of maintaining health benefits for employees. Because the typical private sector, employer-run VEBA is so entwined with an employee-sponsored health insurance plan, such a VEBA qualifies as an "employee welfare benefit plan" under ERISA¹⁷⁰ satisfying the Code's requirements for VEBA management and also subjecting private sector employer plan sponsors to ERISA's fiduciary protections for participants.¹⁷¹

Throughout the middle decades of the 20th century, VEBAs existed primarily as a background funding vehicle for employer-sponsored health plans. Unfortunately, with little regulatory attention being paid,¹⁷² VEBAs also became a convenient corporate tax shelter. Congress reacted in 1969 by extending unrelated business income tax ("UBIT") provisions to VEBA operations.¹⁷³ Concern persisted, however, that VEBAs were being used inappropriately.¹⁷⁴ In the Deficit Reduction Act of 1984 ("DEFRA"),¹⁷⁵ Congress targeted the use of VEBAs as a tax shelter for private, non-unionized companies,¹⁷⁶ adding nondiscrimination

170. 29 U.S.C. § 1002(1) (2006).

171. 29 U.S.C. § 1101(a) (2006) includes employee welfare benefit plans as covered plans for the fiduciary rules of ERISA. Code Section 1104 details ERISA's fiduciary provisions. 29 U.S.C. § 1104 (2006).

172. Regulations under Code Section 501(c)(9) were not even proposed until 1969, and those were not finalized until 1980. Voluntary Employees' Beneficiary Associations, 34 Fed. Reg. 1028 (proposed Jan. 23, 1969) (withdrawn); 26 C.F.R. § 1.501(c)(9)-1-8 (1981).

173. U.S. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 537-8 (codified at 26 U.S.C. § 501(c)(9) (1969)). UBIT applies to any VEBA income that exceeds so-called "exempt function income" (generally, employer contributions for benefit payments and administrative costs and investment income used for the same purposes). 26 U.S.C. §§ 501(b), 511-513 (2006).

174. See John H. Eggertsen & Michael J. Hainer, *Recent Tax Act Affects Employee Benefit Plans*, NAT'L L.J., Oct. 21, 1985, at 15 (stating that "closely held and professional corporations often used group insurance contracts and VEBAs as investment vehicles to defer compensation for highly compensated employees/shareholders").

175. Deficit Reduction Act of 1984 [hereinafter DEFRA], Pub. L. No. 98-369, 98 Stat. 494.

176. See Eggerston, *supra* note 174, at 15 (noting that Congress imposed reserve limits and nondiscrimination rules on VEBAs); Thomas Porcano, *Reconsidering Voluntary Employees' Beneficiary Associations Under the DEFRA*, 16 TAX ADVISOR 130, 130 (1985) (noting that the changes came in response to abusive use of VEBAs to lower tax costs); Russell E. Greenblatt, *Planning for VEBAs Under the Tax Reform Act of 1984*, 62 TAXES 605, 605 (1984) (detailing the major changes under the act); John H. Eggertsen & Michael J. Hainer, *Tax Act: Changes Affecting Many Group Insurance Contracts and VEBAs*, 64 MICH. B.J. 932, 932 (1985) (describing that the law was meant to provide the same tax treatment regardless of whether the

requirements¹⁷⁷ and imposing contribution deduction limits under Code Sections 419 and 419A.¹⁷⁸ The nondiscrimination restrictions do not apply, however, to any VEBA that is “part of a plan”¹⁷⁹ maintained pursuant to a collective bargaining agreement.¹⁸⁰ Contributions to a VEBA maintained pursuant to a collective bargaining agreement are also exempt from the DEFRA deduction limits,¹⁸¹ allowing employers with union health plans to deduct VEBA contributions largely without restriction.¹⁸² Similarly, because Code Sections 419 and 419A target only employer tax deductions, tax-exempt employers such as governmental entities are by their nature removed from the reach of these limits.

DEFRA’s limits also affected the UBIT provisions for VEBAs, linking the calculation of UBIT to an employer’s ability to deduct contributions to the trust.¹⁸³ After DEFRA, only about one taxable year’s worth of health benefit expenses may be contributed by most employers to a VEBA without becoming taxable,¹⁸⁴ in effect negating any long-term potential for tax-free accumulation of assets through the trust. This limit does not apply to VEBAs funded pursuant to collective bargaining agreements, however,

employer paid benefits directly from general assets, purchased group insurance, or established a separate trust fund that held employer contributions in reserve).

177. 26 U.S.C. § 505(b) (2006).

178. DEFRA, Pub. L. No. 98-369, 98 Stat. 854-60. Before the DEFRA, employer contributions to VEBAs were deductible under the Code Section 162 ordinary and necessary business expense rules. DEFRA, Pub. L. No. 98-369, 98 Stat. 854. The DEFRA provided instead that employer contributions to a “welfare benefit fund” (which includes a VEBA providing medical benefits) are deductible under Code Section 419, not Code Section 162. *Id.* Code Sections 419 and 419A then work together to restrict private, non-unionized employers to a maximum annual deduction equal, generally, to one year’s benefit costs plus a small reserve. 26 U.S.C. §§ 419, 419A (2006). *See also* Treas. Reg. § 1.162-10T at A-2 (1992) (explaining the applicability of 26 U.S.C. §§ 419, 419A).

179. 26 U.S.C. § 505(a)(1), (b) (2006).

180. 26 U.S.C. § 505(a)(2) (2006).

181. 26 U.S.C. § 419A(f)(5) (2006). The Code states that “[n]o account limits shall apply in the case of any qualified asset account under a separate welfare benefit fund . . . under a collective bargaining agreement.” *Id.* Temporary Treasury Regulations under Code Section 419A provide further that “neither contributions to nor reserves of such a collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b), 419A(b), or 512(a)(3)(E) until the earlier of [various dates tied to the publication of final regulations under Code Section 419A].” Such final regulations have yet to be published.” Temp Treas. Reg. § 1.419A-2T (1985).

182. 26 U.S.C. § 419A(f)(5) (2006). Deductibility of contributions remains subject to the requirement that they qualify as ordinary and necessary business expenses under Code Section 162(a). 26 U.S.C. § 419(a) (2006).

183. 26 U.S.C. § 512(a)(3)(E) (2006).

184. 26 U.S.C. § 419A(c)(1) (2006).

because employer tax deductions for contributions to such VEBAs are not limited.¹⁸⁵ Similarly, the Code specifically exempts a VEBA from the UBIT limit “if substantially all of the contributions to the [VEBA] are made by employers who were exempt from tax . . .”¹⁸⁶ VEBAs connected to governmental employers thus enjoy the same pre-funding ability and UBIT relief that union VEBAs do.

B. Development of Defeasance or Stand-Alone VEBAs

By 2008, the IRS reported the existence of 11,996 VEBAs,¹⁸⁷ but they were not all the same. Along the way, a new VEBA variation—today often referred to as a “defeasance” or “stand-alone” VEBA—developed.¹⁸⁸ The new style began to appear in the early 1990s after FAS 106 became effective. In 1992, Navistar International Corporation (formerly International Harvester) established a VEBA to offload \$2.6 billion in hourly retiree health costs while the company struggled with massive losses.¹⁸⁹ Navistar and the UAW agreed to a range of concessions (such as premiums, deductibles, and co-payments) that reduced the company’s liability to \$1 billion, which the company contributed to the VEBA primarily in the form of stock.¹⁹⁰ The VEBA then assumed responsibility for retiree health benefits.¹⁹¹ In 1998, the UAW agreed with Caterpillar to establish a VEBA to be funded with approximately \$35 million to cover costs above the company’s

185. See *supra* notes 181-182 and accompanying text. See also I.R.S. Priv. Ltr. Rul. 9401033 (Jan. 7, 1994) (stating that “[a]ccount limits do not apply to any qualified asset account under a separate welfare benefit fund under a collective bargaining agreement.”).

186. 26 U.S.C. § 512(a)(3)(E)(iii) (2006).

187. U.S. DEP’T OF TREASURY, I.R.S. DATA BOOK, 2008 56, tbl 25 (2009).

188. Bernstein, *supra* note 125, at 7-8.

189. O’Brien, *supra* note 126, at 4.

190. The company agreed to fund a VEBA with two subtrusters. *Id.* The first subtrust received approximately \$500 million in newly issued company stock to pay current retiree expenses; Navistar promised to fund the second subtrust with new stock that would represent approximately half of the company’s outstanding shares, operating on the theory that any increase in the stock’s value could be used to lower future retiree health costs. *Id.* See also Peggie R. Elgin, *Mosaic of Solutions Needed to Neutralize FAS 106 Liability*, CORP. CASHFLOW MAG. (Sept. 1993). Jeannie Mandelker, *Facing Deadline, Businesses Are Shifting More Costs to Retirees*, 11 BUS. & HEALTH 18 (1993).

191. *Id.* The VEBA survives today although its financial health is debatable. According to one 2007 report, the Navistar VEBA is underfunded and has been forced to increase retiree co-pays. David Welch & Nanette Burns, *GM’s Health Plan Could Be Contagious*, BUS. WK., Oct. 8, 2007, at 37. On the other hand, UAW President Ron Gettelfinger, in an online Q&A discussion, characterized the Navistar VEBA as being “in excellent shape.” Q&A Live Discussion with Ron Gettelfinger, Nov. 21, 2006, available at http://www.uaw.org/talk/transcript/112106_rg2.cfm (last visited Sept. 19, 2008).

previously announced retiree liability cap¹⁹²—a cap announced in reaction to FAS 106.¹⁹³ This VEBA was expressly structured to be “independent of Caterpillar,”¹⁹⁴ a key feature of the defeasance model. According to Caterpillar, the company “made no promise to provide any additional or future funding to the VEBA or to otherwise pay for retiree health insurance costs above the established caps.”¹⁹⁵

In late 2006, the United Steelworkers (“USW”) and Goodyear Tire & Rubber Company negotiated a new contract that included “the transfer of responsibility for all current and future retiree health care liabilities for Goodyear’s USW workforce to a VEBA trust,” funded by a one-time \$1 billion contribution from the company.¹⁹⁶ Goodyear committed to make at least \$700 million of its \$1 billion contribution in cash and the remaining \$300 million in either common stock or cash.¹⁹⁷ Once the funding is completed,

192. Mem. of Law in Support of Caterpillar’s Mot. to Dismiss, *Winnett v. Caterpillar*, No. 3:06-CV-00235, 2006 WL 5328388, at *1 (M.D. Tenn. Sept. 25, 2006). One newspaper article reported that the UAW itself funded approximately \$32.3 million of the VEBA from a union training fund and an overtime account fund. Paul Gordon, *Caterpillar Warns Union of Escalating Health Care for Workers, Retirees*, J. STAR, Apr. 30, 2004. Another source characterized the funding as a redistribution from overtime pay and training funds for active employees. O’Brien, *supra* note 126, at 5.

193. See *supra* notes 88-92, 121-124 and accompanying text.

194. O’Brien, *supra* note 126, at 5.

195. *Id.* The Caterpillar VEBA has not fared well. See Rick Popely, *Retiree Health Tab Could Fall on UAW*, CHI. TRIB., Sept. 11, 2007, at Business C1 (explaining that the VEBA set up by Caterpillar ran out of funds seven years after it was created). When the VEBA was exhausted (by October 2004) and Caterpillar began charging retirees premiums, groups of hourly retirees sued Caterpillar in 2006, and a federal district court judge in July 2007 certified the class in a class action against Caterpillar. *Winnett v. Caterpillar, Inc.*, No. 3:06-CV-00235, 2007 WL 2044098, at *1 (M.D. Tenn. July 12, 2007); *Kerns v. Caterpillar, Inc.*, No. 3:06-CV-01113, 2007 WL 2044092, at *1 (M.D. Tenn. July 12, 2007). Caterpillar subsequently sued several union locals and the UAW, claiming that they should indemnify Caterpillar for any liability resulting from the retirees’ lawsuits in *Winnett* and *Kerns*. *Kerns v. Caterpillar, Inc.*, 583 F. Supp. 2d 885, 889 (M.D. Tenn. 2008); *Winnett v. Caterpillar, Inc.*, No. 3:06-CV-00235, 2008 WL 1943995, at *1 (M.D. Tenn. May 1, 2008). The company’s lawsuits against certain locals were dismissed on jurisdictional grounds in May 2008. *Kerns*, 583 F. Supp. 2d at 904; *Winnett*, 2008 WL 1943995, at *16. A similar VEBA, negotiated by the UAW with Detroit Diesel Corporation, also triggered litigation when the trust ran short of funds. *Wood v. Detroit Diesel Corp.*, No. 05-74106, 2005 WL 3579169, at *1 (E.D. Mich. Dec. 30, 2005).

196. Press Release, Goodyear Tire & Rubber Co., *USW Ratifies Agreement with Goodyear; Pact Provides Company Substantial Cost Savings*, Dec. 29, 2006, available at <http://www.goodyear.com/media/pr/23411pl.html>.

197. *Id.* The transaction was approved by a federal judge in August 2008 as part of a settlement of a lawsuit brought by two Goodyear retirees. *Redington v. Goodyear Tire & Rubber Co.*, No. 5:07-CV-1999, 2008 WL 3981461, at *19 (N.D. Ohio Aug. 22, 2008).

Goodyear will remove its \$1.2 billion liability for current and future USW retirees from its balance sheet.¹⁹⁸ As is typical of a defeasance VEBA, the agreement provided for the Goodyear VEBA to be completely independent of the company and controlled by a committee with “four Public Members who are healthcare, employee benefits or ERISA experts, . . . three members appointed by the USW, and . . . two [employee representatives].”¹⁹⁹ To ensure the VEBA’s independence from the company, the settlement further specified that no member of the VEBA’s controlling committee “may be a current or former officer, director or salaried employee of Goodyear” and that six of the nine members (the so-called “Public Members” and the employee representatives) cannot “have a financial or institutional relationship with Goodyear or the USW if such relationship could have an impact on his or her judgment.”²⁰⁰

In early 2008, the USW settled a lawsuit with Continental Tire North America over Continental Tire’s unilateral modification of retiree health benefits with an agreement that Continental Tire would fund a VEBA for hourly retiree health benefits.²⁰¹ That agreement provided for the VEBA to receive about \$40 million upfront in cash and to receive additional payments from the company over a twenty-year period, for a total funding of approximately \$158 million in present value terms.²⁰² The agreement also called for the VEBA to be controlled by a five-member committee (composed of two union representatives but no representatives from Continental Tire) with the power to establish benefit levels, including raising or lowering coverage.²⁰³

Similarly, an October 2007 settlement agreement between AK Steel and one of its unions (covering approximately 4900 retirees) provided for the establishment of a VEBA to be funded by the company but managed “solely by the retirees’ designees.”²⁰⁴

198. *Redington*, 2008 WL 3981461, at *12.

199. *Id.* at *5.

200. *Id.*

201. PR Newswire Europe, *USW Lawsuit Results in Continental Tire Agreeing to Provide Retiree Health Care*, Apr. 16, 2008, available at <http://www.reuters.com/article/pressrelease/idus157159+16-Apr-2008+PRN20080416>. Continental Tire had apparently imposed an annual cap of \$3,000 per retiree, shifting significant expense to current retirees. Kristin G. Hunt, *Tire Company Settles Retiree Health Suit*, 42 BUS. INS. 6, 6 (Apr. 21, 2008). The USW sued the company and won in district court. *Id.*; *Pringle v. Continental Tire North America, Inc.*, 541 F. Supp. 2d 924, 934 (N.D. Ohio 2007).

202. Hunt, *supra* note 201, at 6. The VEBA is scheduled to become effective in 2010, assuming court approval of the settlement agreement. *Id.*; Trial Mot. Mem. & Aff., *Pringle v. Continental Tire North America, Inc.*, No. 06-2985, 2008 WL 5740892 (N.D. Ohio Apr. 12, 2008).

203. Trial Mot. Mem. & Aff., *Pringle*, 2008 WL 5740892.

204. Press Release, AK Steel, *U.S. Court Approves AK Steel’s VEBA Health Care Settlement with Middletown Works Retirees*, Feb. 21, 2008, available at

Funding was expected to take four years, but once completed, the company will have no further liability for retiree health benefits for the retirees covered by the VEBA.²⁰⁵ AK Steel's contributions to the VEBA are expected to total approximately \$663 million,²⁰⁶ but the company will reduce its balance sheet liability by about \$1 billion.²⁰⁷ A federal district court approved the agreement in February 2008.²⁰⁸

Both GM and Ford established VEBAs in 2005 to help fund retiree health benefits for union retirees.²⁰⁹ After financial woes triggered special negotiations with the UAW, GM agreed to contribute approximately \$3 billion in cash to a new VEBA over the next six years, plus an additional \$30 million a year in "profit-sharing payments" over a seven-year period and about \$8 million in stock appreciation rights.²¹⁰ Similar negotiations between the UAW and Ford resulted in a commitment from Ford to contribute approximately \$108 million in cash to a new VEBA over the next six years, plus stock appreciation rights.²¹¹ In both cases, the UAW agreed to forego certain bargained-for compensation increases and have those amounts—estimated for the GM VEBA to be worth an additional \$4 billion over a twenty-year period—also contributed to the VEBAs.²¹² The 2005 VEBAs were structured as independent trusts with the terms of the related medical plans carefully negotiated as part of the bargaining agreements with the companies.²¹³ Moving away from the virtually free medical coverage that auto company retirees had previously enjoyed, the 2005 negotiations shifted some costs to retirees through premiums, deductibles and co-payments, with the VEBAs' intended to offset some of the cost-sharing obligation.²¹⁴ The federal courts blessed the settlement agreements in August 2007.²¹⁵

http://www.aksteel.com/news/press_release.aspx?doc_id=626&year=2008
[hereinafter AK Steel Press Release].

205. Press Release, ERISA Industry Committee, *Court Approves VEBA for AK Steel Retirees; UAW Files Suit Seeking Approval of VEBA Agreement with GM*, Mar. 3, 2008, available at <http://www.eric.org/forms/documents/DocumentFormPublic/view>.

206. AK Steel Press Release, *supra* note 204.

207. *Id.*

208. *Bailey v. AK Steel Corp.*, No. 1:06-CV-468, 2008 WL 495539, at *8-9 (S.D. Ohio Feb. 21, 2008).

209. Chrysler did not win special concessions in 2005 from the UAW.

210. *UAW v. GM*, 497 F.3d 615, 624 (6th Cir. 2007). See also Michael Ellis, *GM Health Care Details Emerge*, DETROIT FREE PRESS, Nov. 3, 2005, at Business 1 (detailing GM health-care cuts for UAW retirees and workers).

211. *UAW*, 497 F.3d at 624.

212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.* at 615-37.

All of these VEBAs—auto-related and otherwise—fade in significance, however, compared to the VEBAs negotiated with the UAW by the Detroit auto companies in late 2007. First with GM and later with Ford and Chrysler, the UAW agreed to accept full obligation for all union retiree health benefits, beginning in January 2010, through a VEBA funded largely in advance by the Big Three.²¹⁶ Under the GM agreement, the company committed to a \$24.1 billion upfront cash contribution to the VEBA, effective January 2008, with up to twenty additional annual \$165 million “backstop” payments “any time the VEBA’s funding level is projected to be insufficient to provide current benefit levels for at least 25 years from the date of the required payment.”²¹⁷ Additional funding included a special security tied to GM stock and contributions derived from foregone negotiated compensation increases for current workers.²¹⁸ The agreement also maintained certain caps on retiree cost-sharing obligations that were negotiated under the 2005 settlement agreement, but only until 2011 when that agreement expires.²¹⁹ Even while touting the commitments to preserve low increases in retiree cost-sharing, the UAW acknowledged that “VEBA trustees may need to make benefit adjustments to maintain long-term solvency.”²²⁰

Under the Ford agreement, the company promised to contribute \$15.4 billion to the VEBA, including \$6.5 billion upfront in cash beginning in January 2008 and fifteen \$52 million annual additional cash payments.²²¹ Funding for that VEBA also included a note secured with Ford assets and other securities tied to Ford stock, as well as the value of foregone wage increases by active

216. Ron Gettelfinger & Cal Ropson, *A Message to UAW Retirees*, UAW GM REPORT, 2007, <http://www.uaw.org/contracts/07/gm/gm07.php> (last visited Sept. 28, 2008); *Voluntary Employee Beneficiary Association on Behalf of UAW Ford Retirees*, UAW FORD REPORT HOURLY WORKERS, 2007, http://www.uaw.org/contracts/07/ford/hrly/ford_hr11.php [hereinafter *VEBA on Behalf of Ford Retirees*]; *Voluntary Employee Benefit Association on Behalf of UAW Chrysler Retirees*, UAW CHRYSLER SALARY WORKERS, 2007, http://www.uaw.org/contracts/07/chrysler/sal/chry_sal05.php [hereinafter *VEBA on Behalf of Chrysler Retirees*]. Under each contract, “responsibility for retiree medical benefits will shift to the new VEBA” beginning in January 2010. *Id.* It appears that the UAW plans to run a single VEBA that will have separate accounting for contributions from each of the Big Three automakers and possibly separate terms applicable to each automaker’s retirees. PHYLLIS C. BORZI, HENRY J. KAISER FAM. FOUND., *RETIREE HEALTH VEBAS: A NEW TWIST ON AN OLD PARADIGM: IMPLICATIONS FOR RETIREES 5* (2009). “A single administrative structure has been created with a single VEBA Board of Trustees, but each of the retiree auto company groups will have its own separate plan and separate subaccount within the VEBA trust.” *Id.*

217. Gettelfinger & Ropson, *supra* note 216.

218. *Id.*

219. *Id.*

220. *Id.*

221. *VEBA on Behalf of Ford Retirees*, *supra* note 216.

UAW Ford workers.²²² The agreement also maintained certain limits from the 2005 settlement on increases in retiree cost-sharing obligations at least through 2011 (when the 2005 agreement expires), with a commitment to attempt to maintain those limits another four years but noted that the “VEBA trustees may need to make benefit adjustments to maintain long-term solvency.”²²³

Under the Chrysler agreement, the company promised to contribute \$8.8 billion to the VEBA in a combination of cash and securities.²²⁴ Specifically, the agreement called for Chrysler to contribute approximately \$7.1 billion in cash beginning in January 2008, with up to twenty additional annual payments of \$50 million each intended to serve as “backstop” payments similar to those promised under the GM agreement—i.e., at “any time the VEBA’s funding level is projected to be insufficient to provide current benefit levels for at least 25 years from the date of the required payment.”²²⁵ Funding for the Chrysler VEBA also included two specialized debt instruments tied to Chrysler and foregone wage increases from current UAW workers at Chrysler.²²⁶ The agreement restricted retiree cost increases to limited percentages each year, but reserved to the VEBA’s trustees the power to “make benefit adjustments to maintain long-term solvency.”²²⁷

The bargaining agreements provided that the Big Three/UAW VEBA would be managed by a committee of trustees, independent from the automakers, who would eventually determine what benefits the VEBA funds and on what terms.²²⁸ Other than the funding obligations specified in the 2007 collective bargaining agreements, the automakers would assume no further responsibility for retiree health benefits for union-represented workers.²²⁹ Assuming approval from the Securities and Exchange

222. *Id.*

223. *Id.*

224. *VEBA on Behalf of Chrysler Retirees*, *supra* note 216.

225. *Id.*

226. *Id.*

227. *Id.*

228. Mark Bruno, *United Autoworkers Revving Up the Big Three’s VEBA*, PENSION & INVESTMENTS, May 5, 2008, available at <http://www.pionline.com/article/20080505/REG/90366115> (reporting that the VEBA’s governing committee will be chaired by Robert Naftaly, a former Blue Cross Blue Shield of Michigan executive, with additional committee members to include: Olena Berg-Lacey, a former assistant secretary of labor; Marianne Udow-Phillips, director of Ann Arbor-based Center for Healthcare Quality and Transformation, Ann Arbor, Mich.; Teresa Ghilarducci, a retirement policy expert at the New School for Social Research in New York City; David Baker Lewis, founder of Detroit-based law firm Lewis & Munday; and Ed Welch, director of the Workers’ Compensation Center at Michigan State University’s School of Labor and Industrial Relations in East Lansing, Michigan).

229. *See, e.g., VEBA on Behalf of Chrysler Retirees*, *supra* note 216

Commission, each of the Big Three would remove the FAS 106 liability for UAW retirees from their books, giving their balance sheets a much-needed boost.²³⁰ In August 2007, the federal court reviewing the 2005 settlement agreements between the UAW and Ford and GM noted that GM provided health benefits, between active and retired workers and their spouses and dependents, to approximately 1.1 million individuals at a cost of \$5.4 billion in 2005 alone, the majority of which was dedicated to retiree health costs.²³¹ Ford in 2005 provided health insurance to 590,000 individuals at a cost of \$3.5 billion, again with the majority going to retiree health benefits.²³²

With the establishment of the UAW-run VEBA, the Big Three would offload a total of about \$88.7 billion in healthcare liabilities from their balance sheets²³³ at a cost projected to be about \$56.5 billion in contributions from the three companies, significantly less than the liabilities carried on their financial statements.²³⁴ Under the 2007 agreements, the new VEBA would be responsible for retiree health benefits for an estimated 540,000 retirees, spouses and dependents, taking into account all three companies' union retiree health obligations.²³⁵

(explaining that, beginning January 1, 2010, assuming final court approval by that date, "responsibility for retiree medical benefits will shift to the new VEBA."). See also CONGRESSIONAL RESEARCH SERVICE, U.S. MOTOR VEHICLE INDUSTRY: FEDERAL FINANCIAL ASSISTANCE AND RESTRUCTURING 29 (Jan. 30, 2009), available at <http://www.fas.org/sgp/crs/misc/R40003.pdf>.

230. CONGRESSIONAL RESEARCH SERVICE, *supra* note 229, at 18-19; O'Brien, *supra* note 126, at 6.

231. UAW v. GMC, 497 F.3d 615, 620 (6th Cir. 2007).

232. *Id.*

233. GM was estimated to save \$46.7 billion in retiree health care expenses currently on its balance sheet, Ford about \$23.7 billion, and Chrysler about \$18.3 billion. O'Brien, *supra* note 126, at 6.

234. *Id.* GM was estimated to be funding the VEBA at about 68% of its total liability, Ford at about 60%, and Chrysler at about 57%. *Id.* Beyond the disclosed and quantifiable balance sheet liability, employers also shoulder the burden with any employer-sponsored health plan of compliance with the Code, ERISA, and other applicable laws, plus the day-to-day administrative expenses that accompany running a health insurance program. Even though most employers with VEBAs—like the Big Three—probably also maintain ongoing health insurance programs for active employees and incur the related administrative costs and obligations without regard to the VEBAs, removing large numbers of individuals from the rolls of participants saves employers money. If nothing else, it requires fewer personnel hours to service smaller numbers of participants.

235. *Id.* at 8, 12. The 2008-2009 auto industry bailouts, bankruptcies, and restructuring led to reopening negotiations between Chrysler, GM, and the UAW. See, e.g., David Shepardson, *UAW Balks at Proposals to Change Funding for Retiree Health Care*, THE DETROIT NEWS, Feb. 15, 2009, at Business 1 (reporting the UAW's disagreement with GM and Chrysler's proposal to further reduce cash contributions to the VEBA). The resulting agreements retained the VEBA's independent structure and defeasance

C. Key Features of Defeasance/Stand-Alone VEBAs

The automakers/UAW style of VEBA is sometimes called a “defeasance” VEBA because it in effect voids an employer’s prior commitment to provide retiree health benefits.²³⁶ Unlike traditional VEBAs, the employer bows out of the picture with a defeasance VEBA and puts the VEBA itself at center stage. Other than meeting its agreed-upon funding commitment, the employer is not involved.²³⁷ The VEBA itself assumes the core functions of a health plan—establishing coverage levels and making ongoing administrative decisions—through its operating board.²³⁸ Far from being a mere funding mechanism largely invisible to plan participants, the VEBA becomes the key operating entity.²³⁹ With the defeasance VEBA, employers may assist in establishing the VEBA and may even assist partially in funding it, but they do not control its operation.²⁴⁰ Because of the VEBA’s truly independent nature, this model is also sometimes referred to as a “stand-alone” VEBA.²⁴¹

The new style of VEBA has also been characterized as a “defined contribution” VEBA as opposed to a “defined benefit” VEBA.²⁴² In a defined contribution plan, an employer fixes its

characteristics but altered the funding structure considerably for the two companies then near bankruptcy. Instead of the original cash infusions promised by GM to the VEBA, the revised version provides for the VEBA to be funded by various GM securities and for the VEBA to own 17.5% of the restructured, post-bankruptcy GM. Press Release, U.S. Dep’t of Treas., *FACT SHEET: Obama Administration Auto Restructuring Initiative: General Motors Restructuring* (May 31, 2009), available at <https://treas.gov/press/releases/tg179.htm>. The Chrysler VEBA owns 55% of the equity in the post-bankruptcy company. Micheline Maynard, *Union Takes Rare Front Seat in Deal for Chrysler*, N.Y. TIMES, May 2, 2009, at A1.

236. Bernstein, *supra* note 125, at 7. Mr. Bernstein notes that management side labor lawyers dislike the term “defeasance VEBAs” because “many companies have asserted that retiree health isn’t a legal obligation at all.” *Id.* at 7-8. The debate over termination of retiree health benefits is beyond the scope of this Article. For discussions of the various issues involved, see Lynn A. Karoly & Jeannette Rogowski, *Retiree Health Benefits and Retirement Behavior: Implications for Health Policy*, HEALTH BENEFITS AND THE WORKFORCE, 1998, at 43-71, available at <http://www.rand.org/pubs/reprints/RP836/>; John G. Marcis, *The Uncertain Promise of Retiree Health Benefits*, S. ECON. J., July 1993, at 16; Lauren A. McCormack et al., *Trends in Retiree Health Benefits*, 21 HEALTH AFF. 169, 171-72 (2002); Posting of Michael D. Miller to Health Policy and Communications Blog, <http://www.healthpolcom.com/blog/2009/01/08/auto-industry-retirees-health-benefits-squeezed-again/> (Jan. 8, 2009, 13:11 EST).

237. See Bruno, *supra* note 228 (noting the independent nature of the VEBA’s management).

238. See *id.*

239. See *id.*

240. BORZI, *supra* note 216, at 10.

241. Bernstein, *supra* note 125, at 7.

242. *Id.*

contribution, and employees receive from that contribution only whatever benefits the fixed sum eventually generates.²⁴³ Employees thus depend on the investment success of the amount contributed and cannot rely on an employer promise to provide any particular benefit.²⁴⁴ By contrast, in a defined benefit plan, the employer specifies the end benefit and then bears the risk of saving and investing assets appropriately to meet the obligation when it comes due.²⁴⁵ Just as defined benefit pension plans have given way over the past three decades to defined contribution retirement plans, most notably 401(k) plans, so too has a trend toward defined contribution health plans begun to take hold in employment-based health insurance, albeit much more slowly.²⁴⁶ The type of VEBA exemplified by the automakers/UAW model allows employers to fix their total contribution for retiree healthcare at the outset and largely to avoid responsibility for whether that contribution in fact suffices to provide health benefits in the long run.²⁴⁷ The standard VEBA of the employer-sponsored health insurance era functions more as a defined benefit model because the employer separately promises a certain level of benefits and uses the VEBA to assist in funding the benefits, but in the end remains responsible for any additional assets needed.²⁴⁸ By contrast, retirees in the defeasance VEBA shoulder the burden of expenses that outstrip whatever fixed financial commitment their employers made.²⁴⁹

The appeal of the defeasance VEBAs to private sector employers lies predominantly in their ability to transfer assets that total some amount less than the retiree health liability carried on the employers' balance sheets under FAS 106.²⁵⁰ In the

243. *Id.*

244. *Id.*

245. William Gail & Benjamin Harris, *The Tax Policy Briefing Book: A Citizens' Guide for the 2008 Election, and Beyond*, TAX POLY CENTER, Dec. 4, 2007, <http://www.taxpolicycenter.org/briefing-book/keyelements/savings-retirement/defined-benefit.com>.

246. See Timothy Stoltzfus Jost, *Is Health Insurance a Bad Idea? The Consumer-Driven Perspective*, 14 CONN. INS. L. J. 377, 383 (2008) (asserting that consumer-driven health care had experienced a rapid growth in the first years but "seems to have leveled off").

247. BORZI, *supra* note 216, at 7, 9.

248. See Bernstein, *supra* note 125, at 4 (noting VEBAs can function "like a traditional defined-benefit pension plan and pay[] a fixed dollar amount to cover qualified benefits.").

249. It is precisely this problem that resulted in a lawsuit with the Caterpillar VEBA when it ran out of funds. Popely, *supra* note 195, at Business C1.

250. See O'Brien, *supra* note 126, at 3 (observing that VEBAs offer companies "the opportunity to take future projected liabilities off their balance sheets and, assuming they fund them at a discount, improve their standing in credit markets").

2007 automakers/UAW VEBA, for example, the Big Three committed to fund their VEBAs at a rate equal to approximately 64% of the liability on their books.²⁵¹ Similarly, other defeasance VEBAs have been funded at rates below the employers' total balance sheet liability for retiree health.²⁵² These agreements effectively bump a company's accounting net worth upward once the VEBA takes over.

For union retirees, the stand-alone VEBA model provides some modicum of security in what has become a highly insecure health benefit universe.²⁵³ Although such retirees enjoy protections under collective bargaining agreements,²⁵⁴ those benefit guarantees could prove worthless if the companies on the

251. *Id.* at 6.

252. *See, e.g., supra* notes 189-190 and accompanying text (regarding Navistar's lowering of its \$2.6 billion in hourly retiree health costs to \$1 billion contributed to a VEBA); notes 196-198 and accompanying text (regarding Goodyear's lowering of its \$1.2 billion retiree health liability to \$1 billion contributed to a VEBA); notes 206-207 and accompanying text (regarding AK Steel's lowering of its \$1 billion retiree health liability to \$663 million contributed to a VEBA). Although one criticism of the new VEBA is that no external oversight mechanism exists to guide or monitor the determinations made in the bargaining process, the unions involved so far in negotiating the new VEBAs have had access to expert advice in making their determinations. For example, the UAW relied on Lazard Freres and Milliman, both well-known national consulting firms, for assistance in the 2007 negotiations. *VEBA on Behalf of Chrysler Retirees, supra* note 216. Moreover, both a federal district judge and sometimes an appellate court rule on the fairness of a settlement's terms in the typical defeasance VEBA. *Id.* Of course, whether funding amounts suffice in the long run depends on assumptions about unknown and largely uncontrollable features such as the future cost of healthcare. The UAW acknowledged after the 2007 negotiations that its "bargaining team had to make an assumption about future cost savings." *Id.*

253. Many UAW retirees do not hold this view. Dissidents have characterized the new VEBA as "Vandalize Employee Benefits Again," and numerous anti-VEBA commentaries proliferate on the internet. *See, e.g., UAW's Gettelfinger Adds: "No Interest in Retaining Auto Stock" to World's "3 Biggest Lies,"* CAR CZAR CONSULTING, May 5, 2009, <http://carczarconsulting.com/05/05/uaws-gettelfinger-adds-to-3-biggest-lies-no-interest-in-retaining-auto-stock/>; Posting of Richard to Union Review, <http://unionreview.com/printable/node/413> (Aug. 21, 2007); Posting of Chickwithapen to Factory Rats Unite! Blog, <http://www.charmwrite.com/factoryrats/modules.php?name=Forums&file=viewtopic&t=1420&start=0&postdays=0&postorder=asc&highlight=> (Aug. 15, 2007, 18:42 EST); Posting of Gregg Shotwell to Soldiers of Solidarity, http://www.soldiersofsolidarity.com/LB_A_96.pdf (undated).

254. Outside the collective bargaining context, an employer that no longer wishes to fund retiree health benefits can simply terminate the retiree health plan and be rid of the responsibility—and the related FAS 106 liabilities. Without the contractual obligations imposed through collective bargaining, an employer generally is not required to maintain any type of welfare benefit. *See O'Brien, supra* note 126, at 2 (noting that without a contract, employers can change retiree benefits at any time).

other side of the bargaining tables fail. Retirees face the possibility of losing everything if their former employers implode. To the extent assets are transferred to independent VEBAs,²⁵⁵ however, retirees have a chance of receiving at least some degree of the promised benefits.²⁵⁶ As a result, the VEBA risk may be well worth taking for retirees in faltering industries. In a UAW communication to Ford employees announcing the 2007 VEBA agreement, the union observed that,

while we believe that Ford is both legally and morally obligated to pay retiree medical benefits, the company's obligation is largely unfunded. Continued benefits depend on Ford's financial health. If Ford, which lost \$12.6 billion last year, were to file for bankruptcy, retiree medical benefits could be cut or eliminated entirely.²⁵⁷

The union continued with the observation that "the risk of a future VEBA shortfall is clearly preferable to the risk of relying on Ford to continue providing retiree benefits indefinitely."²⁵⁸ Such better-than-nothing reasoning lies at the heart of retirees' acceptance of defeasance VEBAs and hits at the value of the arrangements as a type of stopgap in the absence of a long-term solution.²⁵⁹

255. The deductibility limits under Code Sections 419/419A and the UBIT rules mean that only collectively bargained VEBAs can pre-fund retiree health benefits through a VEBA without negative tax consequences. See *supra* notes 181-185 and accompanying text. Although the Code could be restored to its pre-1984 form to allow pre-funding of non-union retiree health benefits, an employer without a long-term contractual commitment would still be unlikely to shift significant funds into any employee welfare benefit trust, much less a completely independent one like the new model VEBA. Steven J. Sacher, *Issueman Tackles the New VEBAs*, 35 BNA PENSION & BENEFITS REP. 820 (2008). Companies tend to prefer to maintain as much liquidity as possible, particularly in difficult economic times. *Id.*

256. Proponents of the new VEBA have advanced some arguments that may be overly optimistic. For example, the UAW has suggested that the new Big Three/UAW VEBA will be able to negotiate better prices and control costs as a result of its massive size, yet GM for years has provided health benefits to even more individuals than will the combined automakers/UAW VEBA. See O'Brien, *supra* note 126, at 12 (noting that the UAW may use its size negotiate lower prices, but it must be able to do this better than the automakers to make a difference).

257. *A Message to UAW Ford Retirees*, UAW FORD REPORT (UAW, Detroit, MI), Nov. 2007, at 14, available at http://www.uaw892.org/ford_hourly_report_2007.pdf.

258. *Id.* at 15.

259. Professor Kathryn Moore concludes in an analysis of the "new" VEBA model:

Although the new retiree health VEBAs have received a considerable amount of press in recent months, they are not a panacea for this country's health care financing woes. The new VEBAs are an appropriate vehicle for pre-funding retiree health benefits for some employers, particularly financially distressed employers with significant

V. CONSIDERING THE DEFEASANCE VEBA IN THE PUBLIC SECTOR

State and local governments today find themselves in a situation strikingly similar to the position of many large private sector companies in the early 1990s. In both cases, employers made promises over long periods of time to provide future benefits,²⁶⁰ either ignoring the accumulating liability or perhaps assuming perpetual pay-as-you-go funding. In both cases, then-applicable accounting rules enabled employers to avoid recognizing the true cost of their retiree health promises.²⁶¹ Eventually, first for private sector employers with FAS 106, more than a decade later for public sector employers with GASB 45, changes to the accounting rules triggered financial revelation when employers finally faced the implications of their former commitments.²⁶² Confronted with massive retiree health benefit liabilities, most public sector employers, like their private sector counterparts, simply do not have surplus assets to offset the accounting hits to their financial bottom line.²⁶³ In the recent economic downturn, the economic challenge has become even more acute.²⁶⁴

Like the private sector companies that eventually embraced the defeasance VEBA model,²⁶⁵ governmental employers cannot easily change their benefit packages. Not only are public sector employers heavily unionized like many traditional manufacturers, but they are also constrained in some cases by statutory and constitutional requirements.²⁶⁶ Efforts to modify retiree health benefits have encountered fierce opposition. For example, both Michigan and Utah were sued when they changed provisions relating to various state employee retiree health benefits.²⁶⁷ Both

retiree health care liabilities and large union workforces.

Kathryn L. Moore, *The New Retiree Health VEBAs*, NYU REV. EMP. BENEFITS & EXECUTIVE COMPENSATION, 2008, at § 7.06.

260. See *supra* notes 36-52 and accompanying text (regarding the expansion of private sector retiree health benefits); notes 54-63 and accompanying text (regarding the expansion of public sector retiree health benefits).

261. See *supra* notes 87-98 and accompanying text.

262. See *supra* notes 88-98 and accompanying text.

263. See *supra* notes 99-109 and accompanying text (highlighting the financial challenges facing public sector employees with unfunded retiree health liabilities).

264. See ACADEMYHEALTH, *supra* note 60, at 9-10 (stating that, in December 2008, states were reporting an estimated \$43 billion shortfall).

265. See *supra* notes 125-129 and accompanying text discussing the types of private sector employers that have adopted defeasance VEBAs) and Section IV.B.

266. See *supra* notes 143-144 and accompanying text.

267. *Studier v. Mich. Public Sch. Employees Ret. Bd.*, 698 N.W.2d 350, 354 (Mich. 2005); *Utah Public Employees Ass'n v. State of Utah*, 131 P.3d 208, 209-10 (Utah 2006). See also BERMAN & KEATING, *supra* note 150, at 23.

states eventually won in court,²⁶⁸ and legal restraints may indeed be less than sometimes perceived.²⁶⁹ On the other hand, few employers willingly invite litigation, especially where there is uncertainty,²⁷⁰ and there remain strong traditions of maintaining generous retiree health benefits that may make actual termination of benefits untenable for many public sector employers.²⁷¹

Public sector employers also resemble collectively bargained private sector companies in their ability to take advantage of certain pre-funding options under the Code that are not otherwise available to private sector employers.²⁷² Both types of employers can pre-fund retiree health benefits through VEBAs without adverse tax consequences.²⁷³ In the private sector, collectively bargained employers are specifically exempt from the deduction and UBIT limits that otherwise restrain widespread VEBA expansion.²⁷⁴ Government employers—inherently or expressly—are similarly exempt.²⁷⁵ Government employers even enjoy additional tax-advantaged alternatives such as 115 trusts.²⁷⁶

Even the motivations driving employer retiree health benefit choices are similar between the collectively bargained manufacturers of the past two decades and today's public sector employers. With FAS 106 as well as GASB 45, the concern for employers has not been increased obligations. In both cases, the accounting rules require only disclosure of previous commitments,

268. *Studier*, 698 N.W.2d at 354; *Utah Public Employees Ass'n*, 131 P.3d at 209-10.

269. See, e.g., Phil Fairbanks, *Public Retiree Health Insurance Cost Is a Fiscal Time Bomb*, BUFFALO NEWS, July 1, 2009, at 2, available at <http://www.buffalonews.com/cityregion/buffaloerie/story/565471.html> (quoting a New York State official to the effect that “changes [proposed by the New York governor] can be enacted unilaterally by state lawmakers because the benefits are part of Civil Service Law, not union contracts.”); Robert L. Clark, *Will Public Sector Retiree Health Benefit Plans Survive? Economic and Policy Implications of Unfunded Liabilities*, 99 AM. ECON. REV. 2, 533 (2009) (explaining that while the majority of states' constitutions include provisions for governing retirement plans, “retiree health plans are not accorded similar protected status. Reductions in, or the elimination of, retiree health benefits may be constrained by collective bargaining contracts, but in general legislatures have been more flexible to reduce and modify retiree health benefit plans for public sector employees.”).

270. The situation of private sector employers in the early years of benefit modification and termination efforts resembles the current position of many public employers. It was not yet clear in the late 1980s and early 1990s the degree to which private sector employers are generally free to terminate retiree welfare benefits. CLARK ET AL., *ECONOMICS OF AN AGING SOCIETY*, *supra* note 41, at 115.

271. See *supra* note 59 and accompanying text.

272. See *supra* notes 181-186 and accompanying text.

273. See *supra* notes 181-186 and accompanying text.

274. See *supra* notes 181-186 and accompanying text.

275. See *supra* notes 181-186 and accompanying text.

276. See *supra* notes 137-138 and accompanying text.

not new commitments.²⁷⁷ But that disclosure has financial impact sufficient to drive decision-making. Thus, private employers since the early 1990s have twisted and turned to reduce or eliminate retiree health liability, a goal met with the adoption of defeasance VEBAs.²⁷⁸ Although government employers might seem as though they would focus less on balance sheet considerations, the ramifications of GASB 45 for their creditworthiness should drive them to seek solutions that improve their balance sheets.²⁷⁹

For retirees also, the situations resemble each other. In both cases, anticipated health benefits may not be as secure as expected. In the private sector, the risk has been acute and at times overwhelming with faltering manufacturers.²⁸⁰ In the public sector, of course, retirees need not worry that their prior employers will actually cease to exist, but that does not mean the benefits are safe. While modifying or terminating public sector benefits may be difficult,²⁸¹ even statutory protections can change if public opinion shifts. As noted in a 2007 U.S. Government Accountability Office report, “provisions that lend stability for public sector pensions and retiree health benefits are subject to change . . . ”²⁸² Long-term benefit commitments fundamentally depend on public will, a notoriously fickle matter.²⁸³ Recent news articles and policy briefs suggest that public employees are, in fact, compensated better than private employees.²⁸⁴ Continuing revelations to that effect could undercut the traditional

277. See *supra* notes 89, 96-97 and accompanying text.

278. See *supra* notes 111-129 and accompanying text.

279. *Fitch Ratings Weighs in*, *supra* note 108, at 2 (noting that Fitch Ratings “will focus on understanding each issuer’s liability and its plan for addressing the liability, as well as the soundness of the rationale behind the plan”). In addition, a Fitch report stated that “prudent accumulation of assets in a trust account outside the general fund and well in advance of pay-as-you-go cost escalations can avoid or forestall liquidity problems or tax capacity concerns that might lead to credit deterioration.” *Id.*

280. See *supra* notes 253-259 and accompanying text.

281. See *supra* notes 142-144 and accompanying text.

282. U.S. GOV’T ACCOUNTABILITY OFFICE, STATE & LOCAL GOV’T RETIREE BENEFITS: CURRENT STATUS OF BENEFIT STRUCTURES, PROTECTIONS, AND FISCAL OUTLOOK FOR FUNDING FUTURE COSTS, REPORT NO. GAO-07-1156 39 (2007) (noting that retiree health benefits are easier to change than pensions and, in fact, often can be changed “simply through the annual budget process.”).

283. See Young, *supra* note 108 (noting that “[e]ven if increasing OPEB costs are ‘affordable,’ they may not be politically palatable . . . private sector workers, as voters, who do not have as high a level of health care coverage as their local government employee neighbors, may resist any increases in government taxes or fees to cover higher OPEB contributions.”).

284. See, e.g., Dennis Cauchon, *Public, Private Pay Gap Grows*, USA TODAY, Apr. 10, 2009, at 1A (“The pay gap between government workers and lower-compensated private employees is growing as public employees enjoy sizable benefit growth even in a distressed economy . . .”).

justification for maintaining public employee benefits.²⁸⁵ Relying on public employers, especially in difficult economic times, to provide expensive benefits that are not widely available to the taxpaying public may be almost as risky as depending on struggling private industries.

In light of these comparisons, the defeasance VEBA model bears consideration in the public sector. Public employers need to manage two core problems: the accounting/balance sheet impact of GASB 45 disclosure and the actual mounting cost of retiree health benefits. Although the two problems are inextricably related, the solutions are different. Thus, to avoid any negative impact from GASB 45 disclosure, public employers need only fund the benefits in some way. Particularly because of their tax-exempt and governmental status, public employers enjoy a number of effective alternatives for setting aside funds for this purpose.²⁸⁶ In the short term, just taking steps toward funding in a thoughtful, proactive manner may suffice to mollify the credit reporting agencies, whose opinion is vital for future borrowing needs of the governmental entities.²⁸⁷ Even partial funding eases the accounting impact of disclosure.²⁸⁸

With regard to the accounting considerations and funding benefits, a defeasance VEBA does not necessarily improve the position of a government employer any more than a regular VEBA or another kind of trust. Public employers would be unlikely to win the kind of funding arrangements that have made the defeasance VEBA a boon to struggling manufacturers in the private sector. When private sector companies fund these VEBAs at a lower rate than their booked liability, they actually reduce their obligations.²⁸⁹ Employees and retirees of these companies

285. See *supra* note 26 and accompanying text.

286. See *supra* notes 135-139 and accompanying text.

287. See Fleet, *supra* note 101, at 1 (quoting California State controller John Chiang on GASB 45, stating, "As long as we come up with a methodical, responsible plan to pay for these future obligations, we will satisfy the bond and credit rating agencies . . ."); see also Walters, *supra* note 147 (quoting Parry Young, head of public finance for Standard & Poor's rating agency, as saying, "What we're looking for is a thoughtful plan on how they're going to manage this liability."); MICHAEL A. MORAN, GOLDMAN, SACHS & CO, THE TRILLION DOLLAR QUESTION: WHAT IS YOUR GASB 45 NUMBER? 12 (2007) (concluding, with regard to the credit rating agencies, "that maintaining the status quo is not an option and taking proactive approaches to address the issue will be viewed positively by the rating agencies.").

288. Fleet, *supra* note 101 (stating that "[e]ven if the prepayments are less than the full amount, whatever is put aside can begin earning investment returns that will reduce liability.").

289. See *supra* notes 189-190 and accompanying text (Navistar); notes 196-198 and accompanying text (Goodyear); notes 206-207 and accompanying text (AK Steel); notes 233-234 and accompanying text (regarding the Big Three's lowering of their combined \$88.7 billion retiree health liability to \$56.6 billion

know that they are likely better off to accept something, however undesirable and less valuable than the original commitment, rather than gamble on the future of a financially unstable company.²⁹⁰ Public sector employees confront far less risk. Without the same fear, public sector employees would have little reason to agree to any arrangement that resulted in lower funding of retiree health benefits.

A defeasance VEBA could offer value to public sector employers, however, by transforming the retiree benefit obligation into a defined contribution obligation²⁹¹ instead of the open-ended commitment that has prevailed in the past. Even if employers agree to fund fully the current value of accumulated benefits, plus some ongoing level of benefits, a fixed cost caps the long-term risk to the governmental entities. In addition, although funding for defeasance VEBAs tends to be front-loaded, even the automakers' VEBAs initially included multi-year "backstop" payment provisions that assume future contributions as needed over a number of years.²⁹² For public employers, for whom an upfront infusion of significant amounts of cash could present a nearly insurmountable obstacle, long-term funding could be established according to a prescribed formula.

From the retirees' perspective, whether a defeasance VEBA model would appeal might depend on the perceived risk that benefits will eventually be reduced or eliminated. The more funds can be set aside in an irrevocable and protected trust like a VEBA, the better protection such retirees will enjoy. Of course, shifting to a defined contribution model and putting assets into a protected trust does not require a defeasance VEBA. Any form of VEBA—or other irrevocable trusts earmarked for retiree health benefits—would provide similar protection for assets, and a defined contribution model could be created within the health plan to which a traditional VEBA is linked for funding. However, the defeasance VEBA could offer additional advantages to retirees. The defeasance VEBA model removes employers completely from the benefit planning and decision-making process, moving those crucial functions to independent trustees whose duties run only to covered retirees.²⁹³ In the public sector, where public opinion may drive future benefit choices, removing benefit decisions from the political sphere could have merit and appeal. Public sector retirees might find themselves far more comfortable with the

to be contributed to the VEBA).

290. See *supra* notes 253-259 and accompanying text.

291. See *Fitch Ratings Weighs in*, *supra* note 108, at 2. (reporting on the impact of GASB 45 and stating that it expected "many governments to switch to defined contribution systems for OPEBS—at least for new hires.")

292. See *supra* Section IV.B.

293. See *supra* Section IV.B.

decisions of an independent board. In addition, the independent trustees tend to be the same kinds of experts who manage employer plans, which protects against too much decision-making risk being dumped onto retiree shoulders.²⁹⁴ Thus, the defeasance VEBA structure could provide retirees with many of the same administrative advantages that employer plans offer.

CONCLUSION

In light of the similarities between public and private sector retiree health benefits, the defeasance VEBA model would seem at least to deserve consideration by government employers. But so far, while VEBAs and other trust options appear in funding discussions, the stand-alone VEBA alternative appears absent. Perhaps it seems too far removed from where the public sector perceives itself to be on this issue. At the heart of the defeasance VEBA approach lies the abdication of employer responsibility for retiree health benefits. That might trigger an automatic negative reaction from the public sector, with its long history of rich benefits.

Perhaps that reaction would be appropriate. Certainly, public sector retirees and their advocates would not embrace happily any option with an odor of rejection of long-term commitments by employers, whether legally enforceable or not. On the other hand, retiree health benefits are clearly endangered in the private sector, and they may be slipping that way in the public sector. If the trend towards a defined contribution approach for these obligations continues, the real question should be how best to leverage the employer contribution for retirees. Retirees might want to consider whom they trust—former employers or independent trustees. Admittedly, perhaps hopefully, if the economy stabilizes and national health reform takes place, the stand-alone VEBA may be unnecessary and unattractive in the public sector. The urgency that has driven such VEBAs in the private sector does not exist to the same degree with government plans. While government plans need to take some action, the path can be well-considered. In the end, retirees and government employers must weigh their risks and choose accordingly. They should do so, however, with all their options on the table.

294. See *supra* note 228 and accompanying text.