



# Auto Sector Pension/Healthcare Restructuring Issues

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# Legacy Issues

- Defined benefit plans
  - Vesting of benefits required
  - Minimum funding required
  - PBGC guarantee, employer liability on termination
- Retiree medical (OPEB)
  - No vesting required
  - Funding for existing retirees limited by tax penalties (except for collectively bargained benefits)
  - No government guarantee



# Retiree Benefits Other Than Pension (OPEB)



# GM/Ford OPEB Obligations

- GM
  - 432,000 US retirees
  - \$64.3 billion in US retiree liabilities (assets \$16.9)
  - Health care inflation 5-9%
- Ford
  - 170,000 US retirees
  - \$30.9 billion in retiree liabilities (assets \$)
  - Health care inflation 5-6%



# OPEB Funding Vehicles

- Voluntary Employee Beneficiary Association (VEBA)
  - Tax exempt under IRC § 501(c)(9)
  - Usually set up as trust
- 401(h) account in defined benefit plan
  - Assets used only to pay health costs
  - May be retiree or active
- Funding comes from contributions or transfers from overfunded pension plans un IRC §420



# Right to Modify

- Most courts have held that retiree obligations can be modified or terminated if employer has reserved the right to do so
  - Unlike pensions, no vesting required - *e.g.*, *Sprague v. GM*, 133 F.3d 388 (6th Cir. 1998)
  - But, can't modify if no reservation of rights - *e.g.*, *Bland v. Fiatallis North America* (7th Cir. 2005)
  - Collectively-bargained benefits often have no reservation of rights - *e.g.*, *UAW v. Yard-Man, Inc.*, 716 F.2d 1476 (6th Cir. 1983)



# Modifying in Bankruptcy

- Section 1114 of the Bankruptcy Code provides procedure for negotiating modifications to retiree benefits
  - Retiree committee appointed
  - Debtor proposes modifications “necessary to permit reorganization”
  - Debtor negotiates with retiree committee
  - Court orders modification if no agreement
  - Retirees get claim for benefits eliminated



# Recent Retiree Benefit Bankruptcy Settlements

- Delphi
  - GM to fund \$450 million in VEBA for Delphi retirees
- Dana
  - Non-union - \$78 million
  - Union - \$700 million cash plus \$80 million stock
- Tower Automotive
  - Cash during bankruptcy, claim equal to 20% of retiree benefits in bankruptcy
  - VEBAs will hold more than 50% of unsecured claims



# DOL Exemption to Fund VEBA with Stock

- If stock is used to fund VEBA and it represents more than 10% of VEBA assets, Department of Labor exemption required
  - Navistar PTE 93-69
  - Kinder Morgan PTE 2004-08
  - Wheeling-Pittsburgh PTE 2005-04\*
  - Kaiser Aluminum PTE 2006-19\*

\*Bankruptcy reorganization



# GM/Ford OPEB Modifications 2006

- Negotiated with UAW
  - Premiums, deductibles and caps for retirees set through 2011
  - VEBA's to fund retiree out of pocket
    - GM - \$3 billion cash plus appreciation on 8M GM shares
    - Ford - \$108 million cash plus appreciation on 8.75M Ford shares
    - Additional cash if dividends raised
- Class action litigation involving retirees
  - Modifications approved by court based on financial necessity



# Goodyear VEBA

- Goodyear and USW negotiated last year
  - Goodyear OPEB obligation was \$1.2 billion
  - \$1 billion contribution to VEBA (up to \$300 million can be in Goodyear stock)
  - VEBA will pay all retiree benefits, Goodyear will have no additional responsibility
- Retiree class action filed this week in Northern District of Ohio



# More VEBAAs in the Auto Industry???

- Big 3 are rumored to be discussing Goodyear-type VEBA
- Would eliminate future retiree OPEB obligations but at what cost?



# Pension Liabilities in the Auto Industry



# Defined Benefit Plans in Bankruptcy

- Delphi
  - Defined benefit plan to continue
  - IRS funding waiver, contribution at emergence
  - GM to take back some liabilities
- Tower - defined benefit plan to continue
- Collins & Aikmen - PBGC took plan



# GM/Ford Pension Funding

- GM
  - Assets exceed financial statement liability
  - Salaried plan changed in 2006, reducing pension liability by 2.8 billion
- Ford
  - Pension plans 98.7% funded on financial statement basis (underfunded by \$560 million)
  - New salaried hires after 2003 not covered by defined benefit plan
- PBGC termination liability likely higher but irrelevant outside of bankruptcy



# Pension Protection Act of 2006

- Changes minimum funding dramatically for 2008 and later plan years
  - Deferred effective date for collectively bargained plans
  - Special rules for frozen airline plans, auto parts manufacturer, government contractors
- Annual contribution =  
Amortization of funding shortfall over 7 years +  
Target normal cost



# “Funding Shortfall”

- Funding shortfall = funding target minus assets
- Determined at beginning of plan year
- Some averaging allowed for both assets and the interest rate used for target
- Greater volatility and uncertainty about future funding obligations than under current law
  - particularly for better funded plans



# “Funding Target”

- Benefits valued using high-grade corporate bond rates (AAA, AA and A)
  - 2-year averaging permitted
- 3 different rate segments depending on when benefits are due:
  - Within 5 years
  - between years 5 and 20
  - over 20 years
- At risk plans
  - Assume most valuable for those within 10 years of retirement
  - If at risk for 2 out of past 4 years (phased in over 5 years), funding target increased by 4% plus \$700 per participant



# “At Risk Plan”

- **Definition:**
  - Less than 80% funded in prior year using regular assumptions AND
  - Less than 70% funded in prior year using at-risk assumptions
- **Transition for 80% threshold: 65% in 2008, 70% in 2009, 75% in 2010**
- **For threshold, funding standard carryover balance not subtracted from assets**
- **Special automaker/supplier rule**



# Credit Balances

- Contributions in excess of minimum
- Auto makers have traditionally made contributions in good years to they can use credit balances in down part of cycle
- Two different credit balances under PPa
  - “Funding standard carryover balance”— credit balance at the end of the last year under the old rules
  - “Prefunding balance” for excess contributions made after the new rules effective
- Both subtracted from assets for funding, unless plan is 100% funded



## Credit Balances (cont'd)

- Credit balances can't be used if plan is less than 80% funded
  - Credit balances not subtracted in determining 80% threshold
- Credit balances subtracted from assets to determine whether benefit restrictions, unless employer waives
  - Must be waived for collectively-bargained plans and to prevent lump sum restrictions



# Funding Target Transition

- For plans not subject to the deficit reduction contribution in 2007 (e.g., 90% funded for current liability), 100% funding target reduced to:
  - 92% for 2008
  - 94% for 2009
  - 96% for 2010
- Must be above threshold in every year
- Prefunding balance are subtracted from assets for threshold test, but not carryover balances



# Benefit Restrictions Less than 80% funded

- No amendments increasing benefits EXCEPT
  - Flat dollar plans (e.g., UAW plans) may be amended to reflect increase in average wages
  - Amendments permitted if additional contribution or security provided
- Lump sums limited to lower of:
  - 50% of benefit or
  - PBGC guarantee
- Plan participants must be notified within 30 days after restrictions apply
- Any prefunding of executive non-qualified deferred compensation taxed under section 409A if “at risk”
  - Income inclusion plus 20% additional tax



# Benefit Restrictions Less than 60% funded

- Unless additional contributions or security:
  - No benefit accruals
  - No increases in benefits as a result of salary increases
  - No shutdown or other unpredictable contingent event benefits
- No lump sums
- Plan participants must be notified within 30 after restrictions apply



# QUESTIONS???

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