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Retiree Health Benefits and the U.S. Supreme Court

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On Jan. 25, the Supreme Court of the United States (SCOTUS) issued a unanimous opinion on a rare retiree health benefit (RHB) case that reached the highest court, (M&G Polymers USA v. Tackett, No. 13-1010). The headlines were variations on "High Court Rules for Employer in Retiree Benefits Case." SCOTUS indicated that when an employer gave retirees health care in a collective bargaining agreement (CBA) but was ambiguous about the duration of the benefit, there should not be an inference of lifetime benefits.

In so doing, SCOTUS overturned a ruling that followed a 1983 Appeals Court precedent (UAW v. Yard-man, 6th Cir. 1983) in finding that a CBA that was silent (or ambiguous) about whether the retirees' benefit terminated, should be construed to confer vesting for the retirees' life. The Appeals Court validated that, but SCOTUS disavowed it.

The SCOTUS decision closes a few doors that have been open too long, while also providing some openings. This ruling gives me a springboard for a dive into several topics related to the always uncertain world of RHBs.

Let's start with a question: Why has the vesting and duration of RHB been left unresolved for so long? The question of whether RHB can be changed has affected millions of people, and the Yard-man precedent dates from 1983. The M&G Polymers case decided this year involved a handful of people, but the question decided was asked in countless forums for decades. The lack of a definitive answer from SCOTUS left uncertain not only a segment of the actuarial profession but also a fair portion of the country's aging population—and stock analysts. Yet the nine justices of SCOTUS, often thought to be as split along partisan lines as Congress and the electorate, were unanimous in setting aside the Yard-man precedent. Justice Thomas' opinion went to some length to condemn that 6th Circuit Appeals Court opinion as having been applied indiscriminately across industries for all these years. Why didn't they tell us 30 years ago?

SCOTUS has not had a case before it that provided the platform on which to give an opinion. There were plenty of cases that seemed to hang on the interpretation of the sponsor's commitment to paying the benefit for the long term. The parties reached settlement, however, rather than go to the highest court.

In November's oral argument, Justice Scalia said, "…this thing [the duration of health benefits] is obviously an important feature. Both sides knew it was left unaddressed…." Scalia went on to say twice: whoever loses deserves to lose. This garnered headlines in November and some commentary to the effect that the justice was uncaring. In the larger context of the three or four decade lead-up, however, he was right. Employers and employees, corporations and unions, HR people and CFOs, have known this was important, but, to a large extent, they left it for someone else to decide. When that happens, don't be surprised if you are on the losing side.

The January SCOTUS decision sent the M&G Polymers case back to the Appeals Court, which was told not to rely on the Yard-man precedent, but rather to look to ordinary principles of contract law. SCOTUS refrained from deciding what this particular CBA meant; it usually rules based on principles, rather than analysis of the facts in a case. The case could come back to SCOTUS, as some justices gave indication that further fact-finding might lead to an inference of vesting.

The reason no case was pushed to SCOTUS is probably because the stakes are too high, higher than most want to admit. Having someone else pay for health care as we grow old is extremely valuable, hence the popularity of Medicare. But no feasible legislation addressed the private sector issue.

In the early 1980s, actuarial firms began valuing long-term costs of RHBs, which seemed to parallel pension benefits. Results stunned our clients, as long-term projections had a magnitude far higher than they expected. While the Financial Accounting Standards Board (FASB) proceeded with deliberations that eventually led to accrual accounting for RHBs, the U.S. Congress only tinkered at the edges, resisting the imposition of ERISA-like rules and providing little encouragement for advance funding. Employers began dropping or severely limiting RHBs; lawsuits were brought by unions and retiree groups.

As to common-law recognition of who owed what to whom, here too much was (and is) at stake. Many employers made plan changes that would be considered minor if imposed on active employees—an increase in deductibles or premiums—but they were sued when the changes affected retirees because of the precedent set and union fears that further reductions lay ahead. The employers were willing to continue some benefits if not tied to perpetual support. But a court case going to judge or jury was a wild card—there might be a finding that would give one side total victory in RHBs, but leave in tatters the trust needed to operate the business. So litigation was brought and settled, in a feint-and-parry sequence substituting for negotiations. Settlement might come just before the judgment of a District Court judge or before an Appeals Court ruling, but for 30 years settlement always came before a SCOTUS ruling. This was especially true for the Sixth Circuit (Michigan, Ohio, Kentucky and Tennessee), where the Yard-man decision had put a burden of proof on employers to show that a retiree benefit that was ambiguous about change was not vested.

By 1991, when FASB mandated accrual accounting, several lawsuits had gone to federal Appeals Courts, but with mixed results, some favoring employers as having a right to unilaterally change benefits, others favoring retirees, including Yard-man. Despite this mix, no appeal was taken to SCOTUS. Settlements out of court were the usual result, with neither side getting a "full loaf." The usual actuarial valuation model would overstate the employer's commitment to RHBs, since it assumed that retirees, like pensioners, would get their full loaf, with employers funding trusts in advance to finance lifetime benefits. Settlement terms do not usually disclose how dollar figures are determined, but there were indications that retirees were persuaded with optimistic views of investment returns. Stock markets are not the safest place to invest retirement assets, but only there could sufficient potential returns be found to have the diminished employer financial commitment blossom into full payment of future benefits.

Though most employers were sticking with their RHB programs, they were also tightening eligibility requirements and making other changes. The employer commitment looked like a shaky promise, and I was among those who suggested modeling with a higher discount rate. FASB seems to have never seriously considered allowing high risk rates, although it had pegged pension discounts to observable bond market yield rates. FAS 106 became conventional wisdom for most actuaries. Its reasoning is worth tracing, as is that of the Governmental Accounting Standards Board (GASB), but let's save discussion of accounting for another time. For the remainder of this article, we will consider the implication of the most forceful statement in the SCOTUS opinion: "… when a contract is silent as to the duration of retiree benefits, a court may not infer that the parties intended those benefits to vest for life."

Many RHB programs are loosely ordered, without an explicit contract or with a contract that is silent or ambiguous about duration. Yet the sponsor continues to pay the benefits, and it is foolish to consider them as having no value. Actuarial valuation models are built for those purposes and have a number of ways of addressing the ambiguity of RHB programs. Quantifying uncertainty in financial projections, through present values determined with risky discount rates, was commonplace in the finance world by the 1980s, with insurance actuaries being involved—although few pension actuaries had that experience, as the pension promise was not considered ambiguous, but rather guaranteed. The improved ability of computers to analyze massive amounts of financial market data led to many an MBA student knowing historic relationships between stock and bond yields and identifying equity risk premiums. Actuaries in for-profit insurance companies, given the task of finding which products would have profits sufficient to meet investor requirements, became familiar with the research of Ibbotson and Sinquefield at the University of Chicago's Center for Research in Security Prices and helped set internal rates of return accordingly. Seeking equity profits meant seeking risk and potentially reaping an equity risk premium. Future profits were projected forward and then discounted back to the point of investment with an internal rate of return, to see if the present value of the profits justified the investment.

Insurance regulation (and prudent management) requires reserves to be invested in low-risk assets, but investors in insurance company stocks want

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The actuarial community's understanding of discount rates is not as rigorous or comprehensive as it might be, which is unfortunate because there is a similar vacuum in the economics profession.

returns associated with higher risk. Retirement annuities offered by insurers had similar constraints, but for large industrial corporations that sponsored pension plans, and saw prophecy in the research studies, funding with stocks would be expected to provide higher investment returns. Thus, less cash would be needed upfront to fund pensions and more would be available for other corporate goals. Actuarial consulting firms finding present values of future pension payments used Ibbotson to determine discount rates, based on sustainable expected rates of return for equity and bond investment. Insurance actuaries were using equity discount rates to value uncertain profits, and pension actuaries were using equity discount rates to value pension payments considered certain. Whether payments were certain or uncertain, guaranteed or not, didn't seem to make a difference. Eventually FASB and financial economics moved pension discount rates to the less-risky discount rates more appropriate for guaranteed benefits, but now SCOTUS is reminding us RHBs are often not guaranteed.

Court decisions regarding RHBs gave wide interpretation to the certainty of sponsor commitment. There were few incentives to get employers to pre-fund trusts for the benefits. Few assets were dedicated to future payments of RHBs. This lack of asset-backing is important, of course, but the second most salient aspect of RHBs is the uncertainty of employer commitment. (The No. 1 aspect is that it is incredibly valuable to have another person, or entity, share the cost of your health care as you get older.) As years passed, more employers reduced or terminated the benefits. Mergers-and-acquisitions specialists were not valuing the liabilities at an FAS 106 level, and it did not appear rating agencies or the stock market were either, but quantification methods they used, if any, remained their proprietary secret.

With few actuaries addressing this uncertainty for RHBs of a "lifetime" cash flow, I began speaking and writing about ways to affix present values to promised but uncertain benefits. An approach using a higher risk-adjusted discount rate seemed obvious to me, as I had been one of those insurance actuaries using equity discount rates. There were few RHB assets, so the expected-return-on-assets approach was out, plus FASB had rejected the idea for pensions, tying FAS 87 discount rates to bond yields, regardless of assets. Bonds, with certain cash coupons, were an apt match for the pension promise, but the RHB promise was far less certain, so a discount rate matching bond yields seemed inappropriate. Use of an equity risk premium in the discount seemed a viable alternative.

I detailed several approaches in a 1991 *Contingencies* article. One was to use an annual plan termination decrement. Later I realized this had a kinship with an options pricing model, where probabilities would be assigned to all cash-flow possibilities using some type of lattice model and discounting all of them at a risk-free rate. A 2012 Society of Actuaries (SOA) monograph on valuation volatility published a piece I co-authored that specified positive aspects of a valuation method that explicitly recognized the tentative nature of an employer promise. Advantages were quantified, using examples of typical employer RHB program changes. An appendix addressed discount rates under certainty and uncertainty. (Unfortunately, the version published omitted discussion of RHBs as an employee/retiree asset with an employer put option.)

The recent SCOTUS decision underscores the point about financial obligations based on unilaterally changeable promises. The usual approach seems flawed, and a "terminable," or "rescindable," approach better estimates economic value. Litigation concerning whether specific benefits are permanent and unalterable has been settled for dollar amounts well below FAS 106 values. Actuarial documentation for such amounts, if it was available, seemed to use solid payment projections, but with settlement proceeds invested to yield future asset return indicating high risk. The practical effect is present value based on a risky discount rate.

Assuming the parties to negotiation and settlement also understood that the economic value of RHBs is much lower than shown in financial reports, we have an answer as to why it took so long for SCOTUS to decide a question that had been hanging for three decades. No party to litigation wanted to conclude their case without something to show for it. Both sides want to claim some victory and not be on Justice Scalia's losing end.

As noted above, SCOTUS remanded the M&G Polymers case to the 6th Circuit Appeals Court and a decision there might lead back to another SCOTUS hearing. I suspect there will be a settlement before that happens. Of the several ways for an actuary to aid in arriving at settlement amounts, the easiest modeling approach is probably the use of risk-adjusted discount rates.

The actuarial community's understanding of discount rates is not as rigorous or comprehensive as it might be, which is unfortunate because there is a similar vacuum in the economics profession. In the early 1990s, an Academy task force recognized the problem and advocated a research study, which the SOA sponsored but could not find an academic to complete. In the late 2000s, a more limited RFP went out from the SOA to economic researchers, but again the academic response was inadequate and no work was commissioned.

SCOTUS has given strong indication that RHBs are not to be considered vested unless that was the intention of the employer. The benefits will not disappear overnight, because their value to retirees is significant and an employer's cancellation of benefits sends a signal to employees, customers and investors that most employers would rather avoid. The retirees' benefit will continue to erode, more in troubled industries than in prosperous ones. In the face of the erosion and general uncertainty about the benefits that continue, the actuarial profession should find ways to place a value on the benefits commensurate with that uncertainty.