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FORD AND UAW ENTER THE DERIVATIVES MARKET – RETIREE HEALTH CARE AT RISK

In 2007, Ford Motor Company negotiated a collective bargaining agreement with the United Auto Workers Union, which represents the bulk of its manufacturing workforce. At the heart of this labor agreement is a Voluntary Employee Beneficiary Association, or VEBA, which was set up to take over Ford's health care insurance benefits for retired Ford workers. The VEBA was set up as an independent trust to be controlled by the UAW, which would appoint the board of trustees that would manage the entity. Similar VEBA's were also set up at GM and Chrysler in their collective bargaining negotiations.

At the time these agreements were reached, the UAW leadership pushed aggressively for their approval by rank and file autoworkers by claiming that shifting health care to the VEBA's from the Big Three auto companies would protect UAW retirees against the bankruptcy risk at these companies. In an earlier Research Note ("A House of Cards" 10/03/2007) I pointed out why this was not the case because of the complex risks inherent in the VEBA payment structures.

The new Ford agreement with the UAW greatly increases the risks taken on by the UAW, its VEBA and its active workers and retirees. A review of the terms of the VEBA indicates that Ford is now allowed, *at its option*, to settle up to 50% of its future cash obligations to the VEBA in either cash or Ford common stock. Ford faces three decision points – in 2009, 2010 and 2011. In 2009, Ford can replace its cash obligation with stock valued at $2.00 per share (the price is set to rise to $2.10 in 2010 and $2.20 in 2011) as long as the market price of Ford stock is above $1.00.

This is a radical change in the VEBA payment structure with far reaching consequences for the health of the VEBA and UAW retirees. Unwittingly, the UAW has entered the complex and dangerous world of derivatives trading.

In essence, the UAW has sold Ford an option on the original cash obligation to the VEBA. An option is a financial derivative that grants the holder the right to buy an underlying asset (or settle an underlying liability) at some specified future point in time. In theory, an option has value because it gives the holder a choice that they would not otherwise have.

In this situation, Ford can settle its cash obligation to the VEBA in cash or stock, whichever it deems less valuable at the time. Since Ford stock could fall to less than half the value of the face price of the stock given to the VEBA this agreement allows Ford to cut by 25% its future obligations to the VEBA (50% of 50%). As an example, if Ford owes $100 million to the VEBA in cash in 2009 it can settle that claim in stock as long as the market value of its stock is above $1.00 per share. But it can pay in stock that has a face value of $2.00 per share. Thus, it can settle half of the $100 million obligation with stock with a market value as low as approximately $25 million.

Since the value of Ford stock fluctuates, it will extremely difficult for the VEBA to value accurately the option it has sold to Ford. But the option does have value – *to Ford*. It is not clear if the UAW VEBA received any consideration at all in return for this valuable option.

Given the potential downside risk here, the VEBA may be forced to hold on to the stock it receives and see if its price rises sufficiently to recoup the difference. Or, it can enter into a hedging transaction now in order to protect itself against the downside risk of the option. If so, it would have entered into the derivatives market twice!

But this restructuring of the VEBA payment stream is complicated by the fact that on the other side of the transaction, the VEBA has converted a right to receive consideration in cash into a potential obligation to accept stock. If it accepts stock, it becomes an equity holder in Ford. This is problematic for three reasons.

- First, as Ford's counter party, the VEBA must accept the option as exercised by Ford: either cash or Ford common stock in lieu of the original fixed claim to cash. It will not know which asset it will receive until Ford exercises the option. That makes valuing its assets extremely difficult and, thus, greatly complicates the VEBA's ability to meet its actuarial and fiduciary responsibilities to UAW retirees.

- Second, if Ford elects to pay in stock, that stock may be far less valuable on the open market than the $2.00 or $2.10 or $2.20 per share value placed on the shares since Ford can pay in stock down to $1.00 per share. Once it has the stock, the VEBA must be able to sell it, which requires Ford to agree to register the sale with the SEC. If the VEBA holds on to the stock it has itself then taken on the bankruptcy risk that the VEBA was set up to avoid!

- Third, if indeed Ford goes bankrupt that common stock is likely to be worthless since typically stockholders claims are extinguished in bankruptcies of public companies. In fact, it would be in Ford's interest to pay in stock as it approached bankruptcy since otherwise it would face the VEBA as a creditor not an equity holder and in bankruptcy, creditors stand ahead in line of stockholders.

There is a very good reason that Warren Buffett called derivatives the financial equivalent of "weapons of mass destruction." In this case, the UAW has brought financial WMD into the House of Labor. An explosion is almost inevitable.

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