RESEARCH NOTE

"NEW BOSS SAME AS THE OLD BOSS"

A LOOK AT THE GM/UAW VEBA POST-IPO

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Stephen Diamond, JD, PhD
SCU School of Law
Phone: (408) 554-4813
Email: sdiamond@scu.edu

Overview

General Motor's ability to exit bankruptcy through a public offering of its common stock (the "IPO") depends heavily on the sacrifices of active and retired members of the United Auto Workers (UAW).

In particular, a review of the now public filings of GM related to the IPO indicate the significant concessions UAW retirees made to their health care plan, now nominally controlled by the UAW itself through a Voluntary Employee Beneficiary Association, or VEBA. GM itself told investors in its new prospectus (with emphasis added):

> *We have substantially completed the restructuring of our North American operations, which has reduced our cost base and improved our capacity utilization and product line profitability.*
>
> ***We accomplished this through brand rationalization, manufacturing footprint reduction, ongoing dealer network optimization, salaried and hourly headcount reductions, labor agreement restructuring and transfer of hourly retiree healthcare obligations to the New VEBA.***
>
> *The reduced costs resulting from these actions, along with our improved price realization and lower incentives, have reduced our profitability breakeven point in North America.*

In other words, absent the willingness of UAW members to accept the complex and unpredictable asset structure used to set up the VEBA it is possible GM would not have been able to complete its IPO, as it now has done.

Old VEBA, Old GM, Fragile Asset Structure

As I noted in my original Research Note on the GM VEBA, **Legal Implications of Proposed GM/UAW VEBA**, issued on October 23, 2007, the VEBA was to be established with assets worth at least $30 billion. As I argued then the financial structure of those assets meant that the VEBA failed at its original and fundamental justification: to be genuinely independent of GM itself.

A key part of the problem was the agreement by the UAW to accept a "convertible note" from GM in partial satisfaction of its obligations to retirees. That note was convertible into GM stock just as old GM was heading over the cliff into bankruptcy. In my view the failure of the UAW to make clear to its members the risk inherent in the convertible note was a violation of their fiduciary obligation to those members and was potentially also a violation of the federal securities laws.

New VEBA, New GM, Even More Fragile Asset Structure

The problem was compounded when the UAW then agreed to modifications of the original VEBA asset pool to include more debt and equity issued by New GM. Now, after the IPO, even though GM is presumably in a much healthier economic position, it remains the case that the financial health of the VEBA remains tightly linked to the future health of GM itself.

Yet retirees who are the beneficiaries of the VEBA have no direct ability to influence the UAW's negotiations with GM and it is entirely possible that their interests will conflict with those of active UAW members. It is also possible that GM will use that potential conflict to its advantage in order to secure additional concessions as the company moves forward in its new form.

GM's law firm for the IPO, Jenner & Block, explained in a letter to the SEC dated May 26, 2010, that the VEBA has the following assets:

A. Shares of GM common stock, Series A cumulative perpetual preferred stock and warrants to purchase GM common stock valued at $10 billion at December 31, 2009;

B. A note payable of $2.5 billion (implied annual interest rate of 9%);

C. Cash of $94 million; and

D. Assets held in the Company's Internal VEBA (a separate legal entity), valued at $12.6 billion at December 31, 2009.

So, as of May 2010, the VEBA had assets worth $25.2 billion, nearly 15% less than what the VEBA started out with when first established. Further analysis indicates that the asset structure is even more fragile and dependent on the future of GM.

<u>Let's Do the Numbers</u>

1) The Note.

The "note payable" of $2.5 billion was granted to the VEBA in return for a reduction in the actual cash that Old GM was unable to contribute to the VEBA when it was first established. That note has now been paid down in order to allow New GM to secure new loans from a banking consortium. Jenner & Block stated that GM paid the VEBA $2.8 billion after inclusion of accumulated interest, so the cash amount on hand in the VEBA should now have increased by approximately that same amount.

Presumably it will be invested in the financial markets by the VEBA investment team. But because the UAW granted GM an option to pay off the note early, it has sacrificed a 9% annual interest rate on that $2.5 billion principal amount. Even Warren Buffett would have trouble earning that kind of return with the cash that GM has now paid to the VEBA in exchange for the note. The note also came with certain covenants that allowed the UAW to influence corporate decision making at GM which are now gone.

2) The Equity.

The VEBA's equity position in New GM included as of last spring 262,500,000 shares of common stock, 260,000,000 shares of Series A preferred stock and a warrant to purchase more than 45 million additional shares of common stock. This represented approximately 40% of the VEBA's paper asset value, yet these assets, which as equity are all based on the future financial success of New GM, are now the major source of the link to the health of retiree health care, so to speak.

A. <u>The Preferred Stock.</u> The preferred stock is worth $25 per share (for a face value of $6.55 billion) and GM can, if it wishes, pay a 9% dividend on that stock. If GM refuses to pay dividends, the dividend cumulates over time and must be paid off when GM "calls" (redeems) the stock. GM's call option to repurchase the preferred at the

$25 per share price plus cumulated dividends goes into effect after December 31, 2014.

B. The Warrant. The warrant is an option to purchase GM stock at any point between now and the end of 2015. The strike price for the 45 million shares is $42 per share. Since the IPO has valued GM stock at $33 per share, the Company must increase in value by almost a third in order for the VEBA to break even. That strike price is substantially higher than that granted to the pieces of old GM spun off by New GM into Motor Liquidation Company, or "MLC." The MLC strike prices are $10 per share for one tranche of warrants and $18 for the second. At the current IPO price that means MLC has tripled its investment in the first tranche and nearly doubled it in the second while the VEBA is still "under water."

C. The Common Stock. VEBA plans to sell between 89 million and 102 million of its 262 million shares (including the warrants) in the IPO. If successful in selling, for example, 100 million of these shares at the IPO price of $33 per share, they would receive in cash, $3,300,000,000, or $3.3 billion. After the IPO's completion the VEBA will hold approximately 205 million shares of GM common stock (including the warrant). At today's IPO price that holding is worth a little more than $6.8 billion. But that value must be discounted by the restrictions placed on selling those shares by federal securities laws. Thus, those shares cannot be sold without a new SEC filing by GM, which the VEBA can "demand" be made under certain restrictions. Any such sale will, of course, flood the market with new shares thus potentially causing the price of the stock to fall. It is likely, then, that the VEBA will stage the sell-off of its position over several years.

3) Other.

As the Jenner & Block letter indicates, the VEBA absorbed assets of the old Internal GM VEBA as well as some cash. These total $12.7 billion.

4) Total.

CASH: $6.2 billion

INVESTMENTS IN NON-GM ENTITIES: $12.6 billion

PREFERRED STOCK: 260 million shares at call price of $25 per share (after 2014) plus cumulative dividends.

COMMON STOCK AND WARRANT: 205 million shares, with strike price on 45 million share warrant of $42 per share, limited registration rights on common stock.

<u>Conclusion</u>

In three years the asset value of the VEBA will have changed from a promised $30 billion (which was viewed even then as inadequate) to cash on hand and investments in other entities besides GM valued at approximately $20 billion together with the remaining shares in New GM held by the VEBA.

Valuing those remaining shares is a very tricky business. At today's IPO price the warrant and remaining stock are nominally worth $6.5 billion. But it would be appropriate to apply as much as a 20% discount due to the inability to sell those shares at will: a total of $5.3 billion. If one values the preferred stock in a similar way that adds another $5.3 billion. The grand total of all assets now in the VEBA, then, would be approximately $30.6 billion.

In addition, the links to the future of the US auto industry – the VEBA owns nearly 70% of Chrysler's stock also on behalf of Chrylser retirees – will limit the ability of the VEBA to invest its other non-auto related assets. The VEBA must adopt a more conservative, and therefore less profitable investment strategy, "given the uncertainty over the values of our auto company holdings," the VEBA's new Chief Investment Officer told *The Wall Street Journal* recently.

So after three years of intense and complicated negotiations to save GM, retirees have gained almost nothing and have taken on the much greater risk of a complicated and compromised capital structure. The health of the VEBA remains joined at the hip for the foreseeable future to GM itself, yet breaking that dependency was the very purpose of the VEBA when it was first proposed and sold to UAW members by GM and the UAW leadership.

In that respect, this effort by the UAW and GM must be considered a failure.