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Labor Watch

A Teachable Moment: Will Taxpayers Bail out the NEA?

By RiShawn Biddle

***Summary**: The National Education Association has won expensive compensation packages that have made teaching one of the best-paid professions in the public sector. But the collapse of the NEA's Indiana affiliate after a decade of bad investments and mismanagement of its disability and medical insurance fund has exposed teachers unions to increased scrutiny, and it threatens to put taxpayers on the hook for the unions' failings. States and school districts need to reconsider how they negotiate teachers' pay, and teachers unions must be forced to comply with existing federal financial disclosure reporting requirements, argues education expert RiShawn Biddle.*

In May 2009 the National Education Association (NEA) was forced to take control of the Indiana State Teachers Association (ISTA), one of its most powerful locals. The takeover of the Indiana affiliate was more than a minor embarrassment for the nation's largest teachers union. The NEA acted because ISTA's voluntary employee beneficiary association had become insolvent. A "voluntary employee beneficiary association," also known as a VEBA, is recognized by the IRS as a nonprofit 501(c)(9) group organized to provide disability, medical and life insurance to its members. The Indiana teacher union's VEBA was set up to insure 50,000 Indiana teachers and other school employees and their dependents. The sudden disclosure and subsequent NEA takeover left Indiana teachers wondering what had happened to their insurance and what would now happen to them.

Mike Antonucci, whose Educational Intelligence Agency is a watchdog on NEA activities, has observed: "This is a complicated issue and it isn't likely to simplify soon." An understatement if there ever was one. The Indiana teachers' VEBA is running a $67 million deficit thanks to a series of bad investments and alleged fiscal mismanagement by ISTA and its investment advisers, which included the Wall Street powerhouse Morgan Stanley and the Swiss banking giant UBS. The VEBA's investment portfolio, which included exotic hedge funds, had lost 75 percent of its value over the past two years. The union is now under investigation by the FBI and various state agencies.

Local school districts, which have paid hundreds of millions of dollars into the plan on behalf of teachers and other employees, complain that ISTA and the NEA won't account for some $23 million in excess payments for employee medical claims. At least four districts say they plan to sue ISTA, the NEA, Morgan Stanley, and UBS for recovery of those funds. Indiana's securities commission has also jumped into the fray, filing civil charges against the union in December 2009 for failing to register as a financial adviser and for not disclosing the inadequacy of its reserves.

Rank-and-file teachers, left in the dark by the lack of disclosure, are none too happy with the NEA either. After the NEA took over ISTA and announced that it would stop paying disability benefits, four long-term dependents filed federal and state-level class action suits against ISTA, the NEA, and its investment advisers, alleging they engaged in "collective breaches of fiduciary duties" and made "improper investments." Other rank-and-file members are annoyed that ISTA officials spent months stonewalling them about their VEBA's decline; they are also miffed with the union for bum-rushing them into an eight-percent increase in already-substantial annual dues in order to inch the VEBA towards solvency. "[ISTA] always talked about how careful they were with that money, so I just can't believe it," said Indianapolis teacher Brenda Wiley to the Indianapolis Star. Wiley collects long-term disability benefits from the insurance trust.

Meanwhile ISTA and the NEA are now engaged in a courtroom showdown with ISTA's former executive director, Warren Williams, longtime financial adviser David Karandos and his former and current employers, UBS and Morgan Stanley. Edward Sullivan, the NEA executive who now oversees ISTA, is suing all four players, along with a slew of other advisers and actuaries, for "fraud, negligence, malpractice and breach of contract." The NEA is also buying from ISTA the local's ugly modern headquarters building, which conveniently sits across the street from the union's favorite haunt, the Indiana Statehouse. Although the NEA has long-subsidized the activities of ISTA and other locals, the affiliates technically operate as their own entities.

The collapse of ISTA and its aftermath offers a glimpse into the increasingly high cost American taxpayers will bear for the array of generous defined-benefit pensions, employer-subsidized healthcare plans and job protections negotiated between states and municipal governments and locals of the NEA and its sister union, the American Federation of Teachers. For the past six decades the two unions have used their collective bargaining monopolies, hefty campaign donations and the legions of teachers in their membership to make teaching among the most-lucrative areas of public sector employment. (A teacher in Indiana with 15 years of service can retire and collect pension benefits at age 50, 15 years earlier than the average private-sector worker.)

Taxpayers on the Hook

The taxpayers' liability starts with teacher pensions, which are even more underfunded than those of other public- and private-sector union employees. Taxpayers in Pennsylvania, for example, will shell out $4.2 billion a year by the 2012-2013 fiscal year to keep the state teachers' pension fund afloat, a seven-fold increase over this year's annual payment. And that doesn't include any catch-up payments on the pension's $9 billion underfunding.

Then there are the unfunded healthcare benefits, including long-term disability costs. Disability costs loom large because most states have no reserves to handle them, relying on "pay-as-you-go" accounting. States, municipal governments and school districts have at least $357 billion in uncovered retiree healthcare liabilities on their books, according to a 2007 Standard & Poor's report. California's school districts alone have racked up at least $16 billion in retiree healthcare liabilities – including $5 billion for Los Angeles Unified, the nation's second-largest traditional public school system. The costs, by the way, often don't include the liabilities borne through VEBAs such as ISTA's now-busted plan. At the heart of all these problems are the bad investment choices, financial mismanagement, and overly generous promises that led to ISTA's collapse.

The fallout from ISTA and other scandals may lead states to reconsider how they compensate teachers. Neither the Bush administration's No Child Left Behind Act nor the Obama administration's Race to the Top school initiative focus on the cost of public education compensation. But any future reform effort by states and school districts will have to attend to the high cost of teacher pay and retirement benefits – and the evidence that the quality of academic instruction won't improve until states ditch the traditional compensation model. The current battle between Washington D.C. Public Schools Chancellor Michelle Rhee and the district's AFT union affiliate over a plan to increase teacher pay in exchange for ending teacher tenure is a portent of things to come. (Rhee was profiled in the January 2009 *Labor Watch*).

How will the issue of compensation affect the relationship between teachers unions and teachers? Since the 1960s, when states began requiring school districts to enter into collective bargaining, the NEA and AFT have won teachers' trust by promising generous benefits and comfortable working conditions. But the unions have focused more on protecting the tenure of veteran teachers to the dismay of younger teachers, who are often more interested in merit pay proposals. The alleged mismanagement at ISTA and a spate of financial scandals at other NEA and AFT affiliates may increase teacher skepticism of union promises.

"[The NEA] likes to be one big organization when it's convenient, but then it claims its affiliates and subsidiaries are completely independent when things go wrong," says Antonucci. "If ISTA is found legally vulnerable… it will send tremors throughout NEA and its other affiliates, because they all operate in similar fashion."

Any changes, however, will be incomplete without more-stringent oversight from the U.S. Department of Labor, which can compel transparency by fully enforcing the 1959 Labor Management Reporting and Disclosure Act (Landrum-Griffin Act). The law was passed to compel the disclosure of ties between unions and organized crime. Given the NEA's penchant for insider dealing and commingling funds, this mandated sunlight is a much-needed antiseptic.

A Powerful Force

Few unions rival the National Education Association (NEA) in successfully making government employment as lucrative as work in the private sector. Thanks to its 3.2 million rank-and-file members and the

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$52 million it pours into state and federal elections every year, the nation's largest teachers union has wrangled near-lifetime job protections, generous low-cost health insurance perks, and pensions whose lifetime pay-out can exceed $2 million for each retiring teacher.

ISTA was only the NEA's 17th-largest affiliate, but it wielded the kind of political influence that its sister state affiliates envied. Between 2007 and 2008, the union poured some $1.5 million into Indiana state and local political campaigns, giving money to Democratic incumbents and even a few Republicans, making it one of the biggest donors in state politics. ISTA successfully parlayed this largesse into an influential seat at the table of NEA decision-making. ISTA's white-haired lobbying czar, Dan Clark (who still retains his job) has long had cozy ties with Indiana politicos and bureaucrats who control state government.

Until recently, ISTA wielded even more power in the state's 293 school districts, where its locals are the primary bargaining agents for teachers and other support staff. Besides assuring annual pay increases and "last-hired, first-fired provisions" that protect the most senior teachers, ISTA has extracted generous benefits. In some school districts, teachers receive healthcare coverage at no cost.

One way ISTA has garnered these benefits is through its VEBA, the "Welfare Benefits Plan and Trust." Like other multiple-employer arrangements, ISTA's VEBA administers medical and disability claims on behalf of school districts and teachers, and it selects the HMOs that provide healthcare services. For school districts, ISTA's VEBA seemed to be an especially good deal because the union has promised to credit them with any surplus if annual payments exceed health and disability claims, according to a legal brief filed by the Indiana State Security Commission in its lawsuit against the union**.** School districts also are supposed to earn dividends on the balances once the proceeds are invested.

But to fulfill these promises ISTA would have to bolster its investment gains at the same time that it met its members' medical and disability claims. For two decades VEBA financial adviser David Karandos, now a Morgan Stanley senior vice president, invested the ISTA account in a relatively safe portfolio of stocks and bonds. But in 2004, Karandos (then a UBS vice president) and ISTA executive director Warren Williams began looking for new ways to goose their investment gains. Backed by the VEBA's board, they decided to invest 20 percent of VEBA assets in "alternative" investments, a euphemism for hedge funds and their market plays.

Bad Bets

Hedge funds, illiquid and sparsely-regulated investment vehicles, proved popular with high-net worth investors, Wall Street firms, university endowments and pension funds. Much-admired for their potential to produce hefty gains (and even heftier management fees for the firms that manage them), they proved to be money losers in the hands of less-sophisticated investors facing an unprecedented financial crisis.

Over four years, ISTA poured $76 million of VEBA capital into hedge funds run by such outfits as IKOS Group, a British-Cypriot investment firm, and GP Investments Ltd., a Brazilian private equity firm. Adding to its risk profile, ISTA also invested in collateralized debt obligations (CDOs), the exotic and often difficult-to-divest bonds backed by portfolios of corporate debt structured (in theory) to restrict risk and increase gains. This included something called Eurocastle CDO III, which was assembled by Fortress Investment Group, a private equity group notorious for its lack of financial disclosure. In its legal action the NEA charges that UBS peddled many of these risky VEBA investments.

By 2008, 87 percent of the VEBA's total assets were in alternative investments, which far exceeded of the agreed-upon 20 percent cap, according to the NEA lawsuit.

This came at a most-inopportune time. The collapse of the financial markets – including the CDO and hedge fund sectors – meant ISTA was stuck with investments it couldn't easily sell to pay union member insurance claims. The lack of liquidity also led the hedge funds to subject the VEBA to "capital calls," their legal right to demand promised payments from investors. In 2008, ISTA was required to meet $7.5 million in capital call obligations, even as the value of its hedge fund portfolio was in free-fall.

Even then, ISTA didn't stop making bad investment calls. During a nine-month stretch in 2008, ISTA adviser Karandos – by then working for Morgan Stanley – made some 4,000 trades on behalf of the VEBA in order to liquidate some of its investments. Such dealmaking may have further exposed ISTA to the rampant volatility wreaking havoc on all investors. Then-executive director Williams also allegedly did a favor for Karandos by restructuring the basis of his personal compensation from a percentage of the value of the VEBA's portfolio to a flat fee. The NEA alleges that the restructuring doubled Karandos' pay.

ISTA's fiscal mismanagement didn't stop at the VEBA portfolio. Reserves used to offset increases in long-term disability claims were allegedly used to insure against rising medical claims as well. Such commingling of funds, a bad practice in any case, was even more costly to ISTA because the disability program had already paid out more in claims than it generated in premiums for seven consecutive years. ISTA never increased its premiums to the levels needed to sustain the program. Meanwhile the medical insurance program lost $6 million in one year alone. ISTA itself had a $3.5 million deficit in 2006-2007, the last year for which financials are available, according to the union's 990 filing with the Internal Revenue Service.

Such troubles would have been

discovered more quickly if the VEBA's financial performance was reported in a timely manner, as required in the case of private insurers. But VEBAs aren't subject to similar financial disclosure so there are few triggers for immediate reporting. Oddly enough, ISTA, along with 31 other NEA and AFT affiliates, unsuccessfully sued former U.S. Secretary of Labor Elaine Chao over her effort to increase the kind of financial and conflict-of-interest disclosures that might have alerted rank-and-file members and federal officials to ISTA's growing problems. The heart of their argument – that they weren't subjected to disclosures because they only unionized public school employees – was undercut when the Department of Labor proved that the NEA and AFT (which do represent private-sector employees at the national level) were subsidizing state affiliate activity.

Covering Their, Er, Losses

By February 2009, ISTA's problems attracted the attention of Indiana's Department of Insurance, which had long battled the union over whether its VEBA was subject to state oversight. ISTA finally made the proper filings in May, but state officials discovered that the union hadn't submitted a general ledger to support its 2008 financial statements and couldn't account for the VEBA surpluses that school districts said they were owed. The VEBA's independent auditor also delayed issuing an opinion about its financial condition, raising more questions about the plan's solvency. When ISTA announced that it would increase the VEBA's disability premiums by 20 percent word began to leak out that the program was in trouble. ISTA tried to dampen the alarm of local school district administrators by issuing a memo proclaiming that it "had never missed a claim payment." But the state teachers union also reminded the school districts that they couldn't drop VEBA coverage without the union's permission.

ISTA was unable to pony up the $4.7 million mandated by the state to begin reviving the VEBA, and so it turned to the NEA for help. ISTA officials, including executive director Williams and Robert Frankel, who ran the VEBA's day-to-day operations, "resigned" or "retired," and the NEA brought in Sullivan, a former executive director of its Massachusetts affiliate better known for his skills in defeating a state tax-cutting measure than for his financial acumen**.** Sullivan swept out the old VEBA trustees and sold the ISTA headquarters building to the NEA for an undisclosed sum.

ISTA waited until the day it announced the NEA takeover—May 21—before disclosing to the rank-and-file the collapse of its insurance program. The union further angered its members by then proposing to cut off long-term disability payments to 650 dependents. (Sullivan and the NEA later backed away from that decision.) And it also demanded that members agree to increase their $449 annual dues by another $40 to bolster the VEBA's coffers. Union members approved the dues increase, but teachers Dennis McAllen, Dennis Dittrick, Cheryl Lakes and Shirley O'Neil filed federal and state class action torts demanding recovery of damages. To date they have won motions to end the NEA's solo management of the VEBA, and eight independent trustees have been authorized to oversee the program.

Indiana school districts are asking the NEA and ISTA about the $23 million in surpluses they say the unions owe them, and they are looking to the courts for redress because union officials cannot fully account for the funds. In November, four school districts announced plans to file a class-action tort against the NEA and ISTA to recover the funds (the suit has yet to be filed). Several school districts have abandoned the VEBA for private plans, while others are shifting their disability and medical insurance costs directly onto teachers, ending decades of sweet benefit deals.

Unfortunately, state taxpayers are likely to bear some of the future medical and disability costs of the Hoosier State's teachers. Indiana teacher pensions are underfunded to the tune of $10 billion and the number of retirees has increased two-fold between 1999 and 2008. The pension deficit will continue to grow as more baby boomers in the state's teaching corps begin to retire.

These financial realities, coupled with the state's woeful student achievement statistics, are weakening the NEA's once-potent political influence in Indiana. In December, Tony Bennett, the new state school superintendent, successfully shepherded into fruition measures allowing aspiring teachers to enter the profession through alternative certification programs such as those run by Teach For America, a group that has long aroused the ire of the NEA and its locals. Later that month, when Governor Mitch Daniels cut public school funding by $297 million because of declining tax revenues, the NEA was hard-pressed to fight back.

More Trouble Ahead?

ISTA isn't the only teachers' union affiliate in trouble over financial mismanagement. Earlier in 2009, the insurance unit of the NEA's Hawaii affiliate filed for Chapter 11 bankruptcy after failing to fully report its income. And the AFT's Washington, D.C. local has weathered a stream of scandals, including the conviction of a former president and her cronies for embezzling $5 million from members over a seven-year period.

Antonucci of the Education Intelligence Agency points to other NEA and AFT locals that may have similar problems. At least five other NEA state affiliates – Maine, Michigan, Vermont, Washington State and Wisconsin – operate VEBAs. So do AFT affiliates such as the New Orleans local. More unions are looking to get in on the action: The AFT's state affiliate in West Virginia is teaming up with the affiliates of four other unions, including AFSCME (the American Federation of State County and Municipal Employees) to take over the Mountaineer State's public employee insurance program.

With little federal or state oversight, a variety of teacher union funds are subject to the kind of financial mismanagement that brought down ISTA and that will strain NEA and the AFT budgets that are usually devoted to funding election campaigns and political lobbying inside the Washington, D.C. beltway. As more underfunded VEBAs and pension funds fail taxpayers who have poured millions of dollars into them will be on the hook for billions of dollars in future liabilities.

Financially-troubled VEBAs are but a part of the many teacher compensation packages negotiated every year by unions with state and local school boards that could impose massive future costs on all taxpayers. Many generous pension deals allow for early retirement and some even let union members trade in their sick days for higher annuity payments. These deals, when combined with overly-optimistic actuarial estimates and the over-allocation of pension fund contributions into illiquid investments, have contributed to a $237 billion deficit (as of 2008) among all public pensions, according to Wilshire Associates, an independent investment management firm.

The high cost of teacher retirement bonuses is another scandal in the making that is coming to light thanks to Government Accounting Standards Board 45, which requires state and local governments to fully disclose unfunded retirement liabilities. The expense keeps on growing: States spent more than $50 billion on teacher benefits in 2004 (the last year available), a three-fold increase over the amount 16 years earlier, according to the U.S. Department of Education. The average state spends 28 cents on teacher benefits for every dollar of salary; Indiana, along with West Virginia Wisconsin and Oregon, is one of four states that spend twice that amount.

The costs of such liabilities – and the mismanagement by state governments and school districts – now loom even larger as tax revenues are in a cyclical decline. Some states and school districts have started to rethink how they compensate their teachers. For instance, in 2008 the Clark County school system in Las Vegas began charging current teachers a $15-per-paycheck fee to pay for current and future retiree health benefits; this came about after Nevada closed its health insurance plan to new retirees.

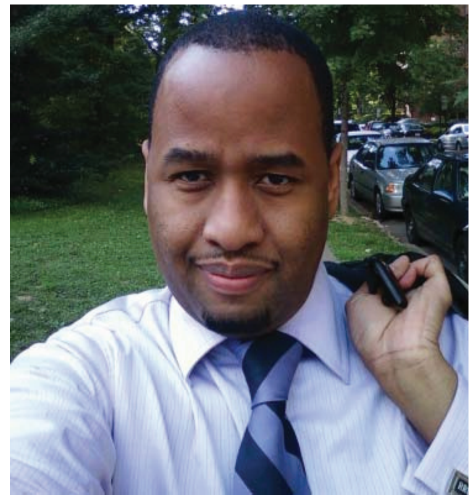
School reformers are beginning to rethink teacher compensation. Merit pay plans, which compensate highly-effective teachers, find favor with younger teachers who benefit little from traditional seniority-based pay. Merit pay proposals are proving to be especially divisive within the AFT, whose rank-and-file teachers work in the nation's largest cities, hotspots for school reform experiments.

But none of this will mean much until federal and state officials learn the lessons from ISTA's collapse. Public sector unions – teachers unions, in particular – cannot be trusted to operate insurance programs without proper oversight. The Obama Administration's decision to not enforce the public disclosure measures enacted by former Labor Secretary Chao guarantees similar blowups down the road.

Heritage Foundation policy experts Dan Lips and James Sherk point out that teacher unions can achieve financial transparency if the Obama administration will simply enforce existing union financial disclosure laws and require teacher unions to complete Labor Department reports such as T-1 forms for VEBAs and other union trusts. Enforcement of the measures under Labor Secretary Chao led to disclosures such as the widespread corruption within the Los Angeles local of the Service Employees International Union. The president of the bargaining unit, Tyrone Freeman, stepped down last year once the Los Angeles Times revealed that the local and one of its charities made $405,700 in payments to companies owned by his relatives. (Freeman was later banned from holding membership or office by the national union.)

Regrettably, it's too late for increased transparency to help Indiana teachers and taxpayers. But enforcing transparency rules may help trim future teacher compensation packages that are no longer affordable.

RiShawn Biddle, the editor of education blog Dropout Nation, is the co-author of A Byte At the Apple: Rethinking Education Data for the Post NCLB Era.



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Terrence Scanlon
President

LaborNotes

Incoming New Jersey Republican governor **Chris Christie** announced that he would nominate former Jersey City mayor **Bret Schundler** as the state's education commissioner. When Schundler was mayor, the **National Education Association** labeled him "Public Enemy Number One" for his advocacy of education choice.

Remember when unions were mad at **John McCain** over his plan to tax "Cadillac insurance plans"? On January 11 **Richard Trumka**, head of the **AFL-CIO** and **SEIU** boss **Andy Stern** met with President **Barack Obama** to plead with him to oppose the Senate version of the health care reform bill, with its tax on expensive, largely union negotiated health care plans. The **New York Times** reported that "one in four [union] members would be hit" by the bill's $23,000 threshold.

At press time, it looked like members of the House of Representatives would move to keep the tax on Cadillac plans but exempt all plans that resulted from collective bargaining, which didn't sit well with some House members. Representative **Raul Grijalva** (D-Arizona), co-chairman of the **Congressional Progressive Caucus**, told the **National Journal** "It's setting up a divide-and-conquer situation here where some people are going to feel they're paying for other people, and they're all working."

Speaking of Richard Trumka, the new AFL-CIO boss predicted at a press event at the **National Press Club** that "you will see the **Employee Free Choice Act**" – commonly referred to as card check – "pass in the first quarter of 2010."

Erroll Southers, the White House's nominee to head the **Transportation Security Administration**, was in trouble in January. Last year Senator **Jim DeMint** put a hold on his nomination over Southers's refusal to rule out unionizing the national security agency. Now, the **Washington Post** reports that Southers "inappropriately access[ed] confidential criminal records 20 years ago about his then-estranged wife's new boyfriend" and made "inconsistent statements" to Congress about it.

What happened to that recovery? In December, according to the **Bureau of Labor Statistics**, the American economy shed 85,000 more jobs. The only reason that the unemployment rate didn't rise from 10 percent is that so many people stopped actively searching for jobs and weren't counted as part of the American workforce. What that means, perversely, according to **Heritage Foundation** analysts **Rea Hederman** and **James Sherk**, is that a slightly higher rate of unemployment later in the year might signal good news.

To render the state eligible for **Race to the Top** federal education dollars, the California legislature passed, and Governor **Arnold Schwarzenegger** signed, a bill that would make it easier to reorganize poorly performing public schools as charter schools, fire bad teachers, and reward effective teachers with merit pay. The **Sacramento Bee** called it a "rare legislative loss" for the **California Teachers Association**.

American Federation of Teachers president **Randi Weingarten** surprised most observers on January 12 by calling for an overhaul of the teacher evaluation process that would make it easier to flag and fire bad teachers.