Q: In September 2003, Lucent published an 8K, which declared that the Voluntary Employee Beneficiary Association (VEBA) trust to fund the Medical Expense Plan for management retirees had been exhausted. A recent audit of the Medical Expense Plan (Plan 504), available from the U.S. Department of Labor, states that there is a loan from the assets of the health trust. Can you explain the nature of the loan and who is authorized to negotiate and sign for such a loan; the corporate purpose for such a loan; the financial implications of the loan on shareholder value; and the reporting of the loan in Lucent's financial statements?

A: In the early 1990s, AT&T established two Voluntary Employee Beneficiary Association ("VEBA") trusts to fund the Medical Expense Plan for Retirees – one for formerly represented retirees and one for non-represented retirees. The VEBA trust for formerly represented retirees is tax-exempt, so the income earned by that trust is not taxable. However, the VEBA trust for non-represented retirees is not tax-exempt, so AT&T invested the assets in several tax-exempt trust-owned life insurance ("TOLI") policies.

The use of TOLI policies in retiree health VEBA trusts is common among companies that prefund retiree health benefits because the policies are tax-efficient and allow for more of the trust income to be used to pay for retiree healthcare, benefiting both the company and its retirees. When AT&T invested in the TOLI policies, it solicited the consent of active management employees, so benefits were payable to the VEBA trust only upon the death of people who had consented to coverage.

The assets of the VEBA trust for non-represented retirees were increased by life insurance payments made by the insurance company to the trust and investment earnings credited to the policies by the insurance company. As permitted under ERISA and tax law guidelines, the trust borrowed against the cash value of one of the policies to help fund retiree healthcare benefits provided to non-represented retirees. This is the loan referred to in the financial statements. Interest and administrative charges were also part of the structure of the policy.

Lucent inherited partially funded VEBA trusts for formerly represented and non-represented retirees when we were spun off from AT&T in 1996. We replicated the structure of the trusts, and as required by generally accepted accounting principles, the outstanding balance of the loan and accrued interest from the TOLI policies have been reflected in the financial statements of the Medical Expense Plan for Retirees. All assets of the non-represented VEBA trust were used to fund retiree healthcare benefits. As part of this process, we decided to surrender the TOLI policies and satisfy the outstanding loans by netting them against the cash value of the policies. The remaining value of the policies was paid to the VEBA. As we have stated previously, the assets of the non-represented VEBA trust were exhausted in 2003.

No Lucent assets were pledged at any time in connection with these policy loans, and Lucent had no liabilities with respect to the loans. Because the transactions were done entirely within the non-represented VEBA trust, we were not required to reflect the loans in our financial statements.

In summary:

1. AT&T and Lucent utilized a common and well-recognized TOLI policy and loan structure to fund retiree health benefits in a tax-efficient way.
2. All assets of the VEBA trust were used to fund retiree health benefits.
3. Having served their purposes, the insurance policy was surrendered and the loan was satisfied in 2003.