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What happens to the GM pensions in bankruptcy?

General Motors (GM) will almost certainly file for bankruptcy next week, triggering the next stage in the ongoing fight to see who will bear the costs of making the company financially viable again. The bankruptcy process allows debts and other claims to be reduced, sometimes dramatically, in an attempt to create a reorganized firm that can actually earn enough to meet its downsized obligations. One large claim that could theoretically be cut back is the unfunded portion of GM's pension liabilities.

GM has made pension promises costing approximately $100 billion in today's dollars. Unfortunately, the investments in its pension funds are worth about $20 billion less than the obligations, according to the Pension Benefit Guaranty Corporation (PBGC). Theoretically, the pension plans could be terminated in bankruptcy to transfer the cost of that underfunding to a combination of the PBGC, which insures pension benefits within certain limits, and existing and future retirees, who would lose the uninsured portions of their pensions. Such terminations have occurred in many bankruptcies over the years, particularly at steel companies and airlines. (Please see, "Understanding the Pension Benefit Guaranty Corporation" for more on pension funding and the role of the PBGC.)

However, GM's pensions appear to be safe for now, as it appears quite unlikely that the pension plans will be terminated as part of this bankruptcy, principally because the United Auto Workers (UAW) and the U.S. government do not want it to happen. As explained below, these key players have the power to block any termination. Of course, the burden of funding these pensions will not vanish and could easily come back in the future to haunt the taxpayers and other owners of the restructured GM.

Underfunded pension plans can usually be terminated in bankruptcy, but this only happens if a restructuring plan is put together that includes such a termination and the bankruptcy judge approves it. In GM's case, management has been working with the unions and the government to devise a restructuring plan that will be proposed to the bankruptcy judge. It is highly likely that the plan will be approved, although there may be some alterations. It appears that GM's management has reached an agreement with the leadership of the UAW that it will not propose terminating the pension plans. This is one of the benefits being offered to the UAW in exchange for a series of concessions on their part.

Even if the agreement not to terminate the plans were to fall apart for some reason, there is a strong chance that the bankruptcy judge would refuse permission to terminate the plans. The Employee Retirement Income Security Act (ERISA), which governs defined benefit pensions, forbids a termination in bankruptcy unless the continuation of the plan would make it too difficult to successfully reorganize the company. This would be a difficult standard to meet in GM's case, for two reasons. The most basic is that GM has a financer lined up for the great bulk of the new funding needed — the federal government, which virtually guarantees an initially successful reorganization. Even without this, the pension underfunding will not require any cash for some time, due to an arcane, but highly important, provision of the pension funding rules, easing the task of finding other funding sources.

GM has large funding credits arising from its choice to put more money into the pension plans in the past than it was required to do. For many years, pension law encouraged such prefunding by allowing any funding in excess of the minimum required to be taken as a credit against funding requirements in future years. In fact, the credit balance grew by an interest rate, to reflect the time value of money. Until the Pension Reform Act of 2006 was passed, there was no provision to have the credit grow or decline based on actual investment performance. Even that Act applies the change only prospectively, leaving GM and a few others with huge funding credits, despite their significant pension deficits. These funding credits will reduce GM's required cash contributions in future years dollar for dollar until the credits are used up. The date at which they vanish will depend on a number of factors that affect what its minimum funding requirements would otherwise be, but the best forecasts appear to be that no cash contributions will be needed until 2013 or 2014.

The absence of a cash drain for a number of years from pension funding requirements makes it hard to argue that the pension deficits make a successful reorganization impossible. In theory, the eventual funding requirement could look so large that investors would stay away from GM, but this seems unlikely in practice. Again, this argument comes into play only to the extent that the government is unwilling to supply the needed funds on acceptable terms. The two reasons taken together make a termination very unlikely this time around.

However, it is critical to remember that the pension problem does not go away just because the plans survive for now. There is a real underfunding of considerable size which will have to be covered out of the operating profits of the restructured GM. If those profits are insufficient, for whatever reason, there could be an eventual second bankruptcy in which the pension plans are then terminated. Restructured companies have certainly gone bankrupt again in the past — think US Airways or TWA, for example — and one cannot be sure that GM is immune.

Therefore, the massive underfunding could still turn out to be a problem for the PBGC, (effectively the taxpayers), and the current and prospective retirees. It is important that all parties keep an eye on the ball to minimize the chance of such a harmful outcome. This makes it all the more critical that the GM that comes out of bankruptcy be truly viable for the long-term.

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