JONES DAY

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LESS STRINGENT STANDARD APPLIES TO REJECTION OF COLLECTIVE BARGAINING AGREEMENTS BY MUNICIPALITIES IN BANKRUPTCY

The devastating consequences of an enduring global recession for businesses and individuals alike have been writ large in headlines worldwide, as governments around the globe scramble to implement assistance programs designed to jumpstart stalled economies. Less visible amid the carnage wrought among the financial institutions, automakers, airlines, retailers, newspapers, homebuilders, homeowners, and suddenly laid-off workers is the plight of the nation's cities, towns, and other municipalities. A shrinking tax base caused by plummeting real estate values and a high incidence of mortgage foreclosures, questionable investments in derivatives and escalating costs, including the higher cost of borrowing due to the meltdown of the bond mortgage industry, and the demise of the market for auction-rate securities have combined to create a maelstrom of woes for U.S. municipalities.

One option available to municipalities teetering on the brink of financial ruin is chapter 9 of the Bankruptcy Code, a relatively obscure legal framework that allows an eligible municipality to "adjust" its debts by means of a plan of adjustment that is in many respects similar to the plan of reorganization that a debtor devises in a chapter 11 case. However, due to constitutional concerns rooted in the Tenth Amendment's preservation of each state's individual sovereignty over its internal affairs, the resemblance between chapter 9 and chapter 11 is limited. One significant difference pertaining to a municipal debtor's ability to modify or terminate labor contracts with unionized employees was the subject of an important ruling recently handed down by a California bankruptcy court. In *In re City of Vallejo*, 2009 WL 773532 (Bankr. E.D. Cal. Mar. 13, 2009), the court ruled that section 1113 of the Bankruptcy Code, which delineates the circumstances under which a chapter 11 debtor can reject a collective bargaining agreement, does not apply in chapter 9, such that it would appear to be easier for a municipal debtor to reject a labor agreement.

MUNICIPAL BANKRUPTCY LAW

Ushered in during the Great Depression to fill a vacuum that previously existed in both federal and state law, federal municipal bankruptcy law suffered from a constitutional flaw that endures in certain respects to this day—the Tenth Amendment reserves to the states sovereignty over their internal affairs. This reservation of rights caused the U.S. Supreme Court to strike down the first federal municipal bankruptcy law as unconstitutional in 1936, and it accounts for the limited scope of chapter 9 as well as the severely restricted role that the bankruptcy court plays in presiding over a chapter 9 case and in overseeing the affairs of a municipal debtor.

The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and state government bailout in 1975, but chapter 9 has proved to be of limited utility thus far. Few cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings involve municipal instrumentalities, such as irrigation districts, public utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 600 municipal bankruptcy petitions have been filed in the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts.

Access to chapter 9 is limited to municipalities. A "municipality" is defined by section 101(40) of the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State." Section 109(c) of the Bankruptcy Code sets forth other prerequisites to relief under chapter 9:

- A state law or governmental entity empowered by state law must specifically authorize the municipality (in its capacity as such or by name) to file for relief under chapter 9.
- The municipality must be insolvent.
- The municipality must "desire[] to effect a plan" to adjust its debts.
- The municipality must either: (a) have obtained the consent of creditors holding at least a majority in amount of claims in classes that will be impaired under the plan; (b) have failed to obtain such consent after negotiating with creditors in good faith; (c) be unable to negotiate with creditors because negotiation is "impracticable"; or (d) reasonably believe that a "creditor may attempt to obtain" a transfer that is avoidable as a preference.

Prior to 1994, the authorization requirement had been construed to require general authority, rather than specific authorization by name, for a municipality to seek chapter 9 relief. However, the Bankruptcy Reform Act of 1994 amended section 109(c)(2) to require that a municipality be "specifically authorized" to be a debtor under chapter 9. As the bankruptcy court explained in *In re County of Orange*, 179 B.R. 177 (Bankr. C.D. Cal. 1995), courts construing the amended provision have concluded that state law must provide express written authority for a municipality to seek chapter 9 relief and that the authority must be "exact, plain, and direct with well-defined limits so that nothing is left to inference or implication."

No other chapter of the Bankruptcy Code includes insolvency among the criteria for relief. "Insolvency" in the context of chapter 9 eligibility does not refer to balance-sheet insolvency. Instead, it requires a showing that as of the filing date, the debtor either is generally not paying its undisputed debts as they become due or is unable to pay its debts as they become due.

The dictate that a municipality "desires to effect a plan to adjust" its debts requires that the purpose of the chapter 9 filing must not be simply to buy time or evade creditors. A debtor need satisfy only one of the disjunctive prerequisites set forth in section 109(c)(5), all of which are unique to chapter 9. The pre-filing negotiation requirements were inserted by Congress to prevent capricious chapter 9 filings.

Section 921(c) states that "[a]fter any objection to the petition, the court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title." No other chapter of the Bankruptcy Code expressly incorporates a good-faith filing requirement. If the court does not dismiss the petition under section 921(c), it "shall" order relief under chapter 9. Notwithstanding its permissive language for dismissal, section 921(c) ("may dismiss") has been construed as requiring dismissal of a petition filed by a debtor that is

ineligible for relief under chapter 9. Dismissal of a chapter 9 case is the only option if the debtor is ineligible—the assets of a chapter 9 debtor cannot be liquidated involuntarily.

CONSTITUTIONAL COMPROMISES

Section 903 of the Bankruptcy Code expressly reserves to the states the power to control municipalities that file for chapter 9 protection, with the caveat—and the significant limitation—that any state law (or equivalent judgment) prescribing a method of composition among a municipality's creditors is not binding on dissenters. Section 904 further provides that unless the debtor consents or the plan so provides, the court may not "interfere" with any of the debtor's "political or governmental powers," any of the debtor's property or revenues, or the use or enjoyment of its income-producing property. Thus, unlike a chapter 11 debtor, a municipal debtor is not restricted in its ability to use, sell, or lease its property (section 363 does not apply in a chapter 9 case), and the court may not become involved in the debtor's day-to-day operations.

In addition, control of a municipal debtor under chapter 9 is not subject to defeasance in the form of a bankruptcy trustee (although state laws commonly provide a mechanism for transferring control of the affairs of a distressed municipality). A trustee, however, may be appointed to pursue avoidance actions (other than preferential transfers to or for the benefit of bondholders) on behalf of the estate if the debtor refuses to do so. A municipal debtor is not subject to the reporting requirement and other general duties of a chapter 11 debtor.

A chapter 9 debtor enjoys many of the rights of a chapter 11 debtor-in-possession but is subject to few of the obligations. Pursuant to section 901, many provisions contained elsewhere in the Bankruptcy Code are expressly made applicable to chapter 9 cases. These include, among others, the provisions with respect to the automatic stay, adequate protection, administrative priority or secured post-petition financing, executory contracts, administrative expenses, a bankruptcy trustee's "strong arm" and avoidance powers, financial contracts, the formation of official committees, and most, but not all, of the provisions governing vote solicitation, disclosure, and confirmation of a chapter 11 plan.

As with chapter 11, the raison d'être of chapter 9 is confirmation of a plan (either consensually or otherwise), but with one significant difference noted earlier—a municipal debtor may not be liquidated in chapter 9. Only the chapter 9 debtor has the right to file a plan and, indeed, is obligated to file a plan, either with its petition or within such time as the court directs. The confirmation standards are comparable to those under chapter 11.

If the debtor cannot confirm a plan, the only option available to the court (and creditors) is dismissal of the chapter 9 case. Under section 930, the court may dismiss a chapter 9 case for "cause," which includes unreasonable delay by the debtor that is prejudicial to creditors, failure to propose or obtain confirmation of a plan, or material default under a plan after it has been confirmed. If the court refuses to confirm the debtor's plan (either on the first attempt or after giving the debtor additional time to modify the plan or propose a new one), it "shall" dismiss the chapter 9 case. Dismissal is appropriate even if the debtor is clearly insolvent and the creditors would be better off if the chapter 9 case were not dismissed.

REJECTION OF LABOR CONTRACTS IN BANKRUPTCY

Section 365 of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor-in-possession to assume or reject most kinds of contracts or agreements that, as of the bankruptcy filing date, are "executory" in the sense that both parties to the contract have a continuing obligation to perform. For most kinds of contracts, the bankruptcy court will authorize assumption or rejection provided it is demonstrated that either course of action represents an exercise of sound business judgment.

Until 1984, courts struggled to determine whether the same standard or a more stringent one should govern the decision to reject a collective bargaining agreement. The U.S. Supreme Court answered that question in 1984, ruling in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), that a labor agreement can be rejected under section 365 if it burdens the estate, the equities favor rejection, and the debtor made

reasonable efforts to negotiate a voluntary modification without any likelihood of producing a prompt satisfactory solution. The court also held (by a five-to-four majority) that a bargaining agreement in bankruptcy is "no longer immediately enforceable, and may never be enforceable again."

Congress changed that later the same year, when it enacted section 1113 of the Bankruptcy Code in response to a groundswell of protest from labor interests. Section 1113 provides that the court "shall" approve an application to reject a bargaining agreement only if:

- the debtor makes a proposal to the authorized representative of the employees covered by the agreement;
- the authorized representative has refused to accept the debtor's proposal without good cause; and
- the balance of the equities clearly favors rejection of the agreement.

The provision ensures that a chapter 11 debtor-employer cannot unilaterally rid itself of its labor obligations and, instead, mandates good faith negotiations with the union before rejection may be approved. To that end, section 1113 carefully spells out guidelines for any proposal presented by the debtor to the authorized labor representative. Underlying these guidelines is the premise that all parties must exercise their best efforts to negotiate in good faith to reach mutually satisfactory modifications to the bargaining agreement and that any modification proposal must treat all creditors, the debtor, and other stakeholders parties fairly. Each proposal must be based on the most complete and reliable information available and must "provide for those necessary modifications in the employees benefits and protections that are necessary to permit the reorganization of the debtor."

SECTION 1113 INAPPLICABLE IN CHAPTER 9

Section 1113, however, does not apply in chapter 9 cases—it was conspicuously omitted from the list of Bankruptcy Code provisions incorporated into chapter 9 under section 901. Although the reason for the omission is unclear, commentators have suggested that Congress excluded the provision due to constitutional concerns, opting to leave to the states, when authorizing municipalities to resort to chapter 9, the decision as to whether and under what circumstances a collective bargaining agreement with a municipal debtor can be modified. In 1991, Congress considered adding a provision to chapter 9 (section 943(b)(7)) that would have required a municipal debtor to exhaust state labor law procedures before rejecting a collective bargaining agreement. However, the proposed bill, denominated the Municipal Employee Protection Amendments of 1991, H.R. 3949, 102 Cong. (1991), died in committee and was never enacted into law. Thus, it was unclear what standard would apply (*i.e.*, the standard in section 1113 or the less restrictive requirements in section 365) if a municipal debtor were to attempt to reject a collective bargaining agreement.

ORANGE COUNTY

The California bankruptcy court presiding over the chapter 9 case of Orange County, California, purported to answer that question in 1995. With a population exceeding 2.8 million, Orange County filed the largest chapter 9 case in U.S. history in 1994 after more than $1.6 billion in losses in its investment pools precipitated an acute and immediate financial crisis. Facing a projected budget shortfall of approximately $172 million, a management council appointed to devise cost-cutting measures recommended that many of the rights of county employees under various memoranda of understandings specifying wages, hours, and terms and conditions of employment be eliminated. Ten county employee organizations that had formed a coalition to oppose the resolution sued the county in state court to enforce the labor contracts. That litigation was later removed to the bankruptcy court, which conducted a hearing on the coalition's emergency request for an injunction preventing permanent employee layoffs.

The bankruptcy court granted the injunction. Orange County argued that the Supreme Court's ruling in *Bildisco* gives a municipal debtor the flexibility to make unilateral changes to its collective bargaining agreements because section 1113 does not apply in chapter 9 cases. The coalition countered that state rather than federal law should apply consistent with the dictates of sections 903 and 904 of the Bankruptcy Code, and that California statutory and case law provide a mechanism by which municipalities and their employees are

to negotiate and resolve their differences. In accordance with the California Supreme Court's 1979 ruling in *Sonoma County Organization of Public Employees v. County of Sonoma*, 591 P.2d 1 (1979), a municipality must satisfy a four-part test before impairing employees' rights under a bargaining agreement on the basis of an emergency:

1 A declared emergency must be based on an adequate factual foundation.

2 The agency's action must be designed to protect a basic social interest and not benefit a particular individual.

3 The law must be appropriate for the emergency and obligation.

4 The agency decision must be temporary, limited to the immediate exigency that caused the action.

The bankruptcy court in *County of Orange* concluded that "*Bildisco* applies in Chapter 9 since Congress has had numerous opportunities to limit its effect by incorporating § 1113 into Chapter 9."

Even so, the court emphasized, this does not mean that a municipality in bankruptcy can unilaterally breach a collective bargaining agreement with its unions without limitations. According to the bankruptcy court, "any unilateral action by a municipality to impair a contract with its employees must satisfy… [the *Sonoma*] factors if not as a legal matter, certainly from an equitable standpoint." The court explained that *Bildisco* does not excuse a municipality from complying with applicable state law. Although unilateral action may be justified in an emergency, the court concluded, Orange County, having declared an emergency, was obligated to satisfy the *Sonoma* factors before taking steps to modify, breach or terminate its collective bargaining agreements:

> Chapter 9 recognizes the interests of the state and a proper balance between state and federal interests. This balance requires that when modifying contractual rights under municipal collective-bargaining agreements, municipalities must view unilateral action as a last resort.

CITY OF VALLEJO

Bankruptcy Judge Michael S. McManus recently rejected this approach in *City of Vallejo*. Vallejo, a city located in Solano County, California, with 117,000 residents, filed for chapter 9 protection on May 23, 2008, after the deficit in its general operating fund ballooned to $17 million due to significantly decreased revenues from property taxes, sales taxes, assessments, and fees. Less than one month afterward, Vallejo moved to reject collective bargaining agreements with four groups of unionized employees, including police officers, firefighters, electrical workers, and administrative and managerial personnel. The city and two of the affected unions ultimately reached a settlement, leaving rejection motions pending with respect to bargaining agreements with firefighters and electrical workers. According to *Vallejo*, the standard for rejection articulated by the Supreme Court in *Bildisco* governs its request for relief because section 1113 does not apply in chapter 9 cases.

After closely examining the constitutional underpinnings and legislative history of chapter 9, Judge McManus ruled that "section 1113 is not applicable in chapter 9 cases, and a chapter 9 debtor is not required to comply with it in order to reject an executory collective bargaining agreement." According to the judge, Congress enacted section 903 to harmonize two competing interests—"reservation of powers to the states and the supremacy of federal bankruptcy law." Together with the Bankruptcy Code's provisions governing eligibility to be a debtor, he explained, section 903 permits states "to act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code." When a state authorizes its municipalities to file for chapter 11 relief, Judge McManus emphasized, "it declares that the benefits of chapter 9 are more important than state control over its municipalities. This means that any state authorizing access to chapter 9 "must accept chapter 9 in its totality" rather than cherry picking some provisions and discarding others. As such, the judge concluded, if a municipality is authorized by the state to file a chapter 9 petition, the municipality "is entitled to fully utilize 11 U.S.C. § 365 to accept or reject its executory contracts."

Judge McManus found that the California statute authorizing chapter 9 relief for California municipalities provides the "broadest possible state authorization for municipal bankruptcy proceedings." Moreover, he concluded that no California law imposes pre-filing limitations or post-filing restrictions requiring compliance with public sector laws. Judge McManus ruled that a municipal debtor's decision to reject a collective bargaining agreement is not governed by California labor law but by section 365 of the Bankruptcy Code. Furthermore, he noted, any California law that purported to superimpose California labor laws onto section 365 would be unconstitutional by operation of the Bankruptcy Clause (Art I, § 8, cl. 4), the Supremacy Clause (Art VI, cl. 2), and the Contracts Clause (Art. VI) of the U.S. Constitution. Judge McManus flatly rejected the assertion that *Sonoma County* or any state labor law provides the standard controlling rejection of Vallejo's collective bargaining agreements, explaining that any such laws are preempted by section 365.

OUTLOOK

Despite his conclusion that neither section 1113 nor California labor law applies to Vallejo's motion to reject its two remaining bargaining agreements, Judge McManus deferred his ruling on the merits of the motion "to give the parties every reasonable opportunity" to reach a settlement, and he suggested at a status conference on March 23, 2009 that mediation might be appropriate to settle the dispute. Given the less stringent standard for rejection under section 365 and *Bildisco*, Vallejo's unions now have a powerful incentive to come to terms. However, the ruling is not a positive development in all respects for municipal debtors. In pre-section 1113 cases, courts recognized that rejection of a collective bargaining agreement under section 365 created an unsecured pre-petition claim for damages by operation of section 502(g). Courts applying section 1113 disagree as to whether rejection of a labor agreement gives rise to any claim for damages, principally because section 502(g) refers to contract rejection under section 365 but not under section 1113. Thus, while it may be easier for a municipality to reject a collective bargaining agreement under section 365, the consequences of rejection may be less palatable.

Even though chapter 9 of the Bankruptcy Code has been in effect for more than 30 years, fewer than 200 chapter 9 cases have been filed during that time. Municipal bankruptcy cases are a rarity, compared to business reorganization cases under chapter 11. The infrequency of chapter 9 filings can be attributed to a number of factors, including the reluctance of municipalities to resort to bankruptcy protection due to its associated stigma and negative impact, perceived or otherwise, on a municipality's future ability to raise capital in the debt markets. Also, chapter 9's insolvency requirement appears to discourage municipal bankruptcy filings.

Until Vallejo's chapter 9 filing in 2008, Bridgeport, Connecticut (pop. 138,000), was the only large city even to have attempted a chapter 9 filing, but its effort to use chapter 9 in 1991 to reorganize its debts failed because it did not meet the insolvency requirement. In 1999, mid-sized Camden, New Jersey (pop. 87,000), and Prichard, Alabama (pop. 28,000), also filed for chapter 9. Camden's stay in chapter 9 ended abruptly when the State of New Jersey took over the failing city in 2000. Prichard confirmed its chapter 9 plan in October 2000. When Vallejo filed its chapter 9 petition last year, the San Francisco suburb became the largest city in California to file for bankruptcy and the first local government in the state to seek protection from creditors because it ran out of money amid the worst housing slump in the U.S. in more than a quarter century. Orange County was the other prominent municipality to have taken the plunge. Having filed the largest chapter 9 case in U.S. history and confirmed a plan in 1995, Orange County stands alone as the only large municipal debtor to have navigated chapter 9 so far.

That may change soon. Jefferson County, Alabama, a county perched on the foothills of the Appalachian Mountains with 660,000 residents and home to the state's largest city (Birmingham), may supplant Orange County as the largest municipal debtor in our nation's history. Jefferson County entered into a series of complex bond swap transactions over the past decade worth a staggering $5.4 billion after incurring a mountain of debt to finance a new sewer system. The county is now staggering under $3.2 billion in debt (or

roughly $7,000 per resident) that it cannot pay. A combination of defaulted debt and the legacy of widespread municipal corruption in connection with the sewer project may soon propel the county into chapter 9, a course of action recommended on March 24, 2009, by county commissioners overseeing county finances, tax collection, and infrastructure.

The only alternative to chapter 9 is restructuring by the municipality under applicable state law, which may be difficult and require voter approval. The ability under chapter 9 to bind dissenting creditors without obtaining voter approval may make that option preferable. Thus, as the financial problems of municipalities continue to mount, there may be a significant surge in chapter 9 filings. The additional leverage afforded to municipal debtors with labor contracts by the court's ruling in *Vallejo* may make chapter 9 even more attractive.

Chapter 9's utility in dealing with some of these problems may be limited. For example, to the extent that a municipality's questionable investments include securities, forward or commodities contracts, or swap, repurchase, or master netting agreements, bankruptcy (and the automatic stay) will not prevent the contract parties from exercising their rights. Also, although a chapter 9 debtor can restructure its existing debt, new long-term borrowing is unlikely to be obtained at any favorable rate of interest. Still, the suspension of creditor collection efforts and the prospect of restructuring existing debt may mean that chapter 9 is the most viable strategy for many beleaguered municipalities.

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