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Bildisco Rising: The Rejection of Public CBAs under *Vallejo II*

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Financially troubled private entities have not cornered the market on unionized labor costs and legacy liabilities. The increase in chapter 9 filings and the highly publicized discussions of potential chapter 9 filings make clear that public entities face these same economic challenges. This article considers the ability of municipal debtors to shed the costs imposed by collective bargaining agreements (CBAs) in light of the recent decision of *In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Calif. 2009) (*Vallejo II*).

When it comes to shedding the costs imposed by collective bargaining agreements (CBAs), a recent California bankruptcy decision demonstrates that municipal debtors face a much lower burden in chapter 9 bankruptcy cases than their private counterparts do in chapter 11 cases. See *In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Calif. 2009) (*Vallejo II*). The *Vallejo II* court confirmed that chapter 9 debtors only need to satisfy the standard announced by the U.S. Supreme Court in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984) (*Bildisco*). In contrast, chapter 11 debtors must comply with and satisfy the procedures and standards embodied in §1113 of the Bankruptcy Code, which Congress enacted after *Bildisco*.

The *Vallejo II* Decision

Early in its chapter 9 case, the City of Vallejo, Calif., filed a motion to reject CBAs between the City and four public employee unions. When the evidentiary hearing commenced in early February 2009, the City reached supplemental agreements with two of the unions: the Vallejo Police Officers Association and the Confidential,

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Administrative, Managerial and Professional Association of Vallejo. The City dismissed its motion with respect to these CBAs. The rejection of two CBAs as between the City and the International Association of Firefighters, Local 1186 (IAFF), and the International Brotherhood of Electrical Workers, Local 2376 (IBEW), remained pending before the court. On March 13, 2009, the court announced the appropriate standard for rejecting these CBAs, but declined to rule based on the evidence before it. Instead, it ordered the parties to mediate—presumably expecting that the announcement of a controlling legal standard would bridge whatever gap remained between them.

Constitutional Issues Involving State Sovereignty

In analyzing whether chapter 9 permits a municipality to reject a CBA with its public employee unions, the court began with a constitutional quandary. On the one hand, the Supremacy Clause embodied in article VI of the U.S. Constitution elevates federal bankruptcy law over conflicting state law. *See Vallejo II*, 403 B.R. at 75. On the other hand, adjudication of issues related to a state’s ability to control the employment terms of its own labor force in federal court raises Tenth Amendment considerations.

The court pointed to two complimentary sections of the Bankruptcy Code that ensure chapter 9 cases accord respect for state sovereignty. Section 903 provides the first of these savings provisions and states in relevant part:

||| This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality.

Id. Section 109(c)(2) of the Code provides the second savings provision. Under §109(c)(2), a state must authorize municipalities to file a chapter 9 petition, and in doing so, it legislatively “declares that the benefits of chapter 9 are more important than state control over its municipalities.” *Id.* at 76. Having done so, a state “must accept chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest.” *Id.* (quoting *In re County of Orange*, 191 B.R. 1005, 1021 (Bankr. C.D. Calif. 1996)).

Enter California State Law

California’s broad statute authorizing municipal bankruptcies contains significant limiting language: “Except as otherwise provided by statute, a local public entity in [California] may file a petition and exercise powers pursuant to applicable federal bankruptcy law.” *Vallejo II*, 403 B.R. at 76 (quoting Cal. Gov’t. Code §53760 (2009)). While the court observed that California enacted specific statutory limitations, compliance with state labor laws was not among them. *Id.*

Any attempts by California to superimpose state labor law requirements upon the rejection of CBAs in bankruptcy fail to pass muster. The court reasoned that the Bankruptcy Code includes a specific provision for the rejection of executory contracts —§365. Three separate provisions of the U.S. Constitution restrain state intrusions into this area of federal concern: the Bankruptcy Clause, art. I, §8, cl. 4; the Contracts Clause, art. IV; and the Supremacy Clause. *Id.* at 77.^[1]

Reprise: The Bildisco Standard

Since CBAs are executory contracts, §365 of the Code generally governs their acceptance or rejection. However, Congress enacted §1113 to specifically provide the “ground rules” by which CBAs may be rejected in chapter 11 cases. Given this backdrop, the question naturally arises: which section applies in a chapter 9 case?

Section 901(a) of the Bankruptcy Code supplies the answer. Section 901(a) incorporates provisions from other sections of the Code into chapter 9. Section 365 is included; §1113 is not. *See id.* at 78. Legislative history validates this statutory interpretation. Congress considered adding a provision to chapter 9 in 1991 that would require a municipal debtor to comply with all state labor law requirements prior to rejecting a CBA. *Id.* at 78 (discussing the Municipal Employee Protection Amendments of 1991, H.R. 3949, 102d Cong., 1st Sess. (1991)). The proposed legislation, however, died in committee. *Id.* at 78 n.1.

Based on this statutory interpretation, the court held that *Bildisco*, which applied to the rejection of CBAs prior to the adoption of §1113, provides the legal framework for deciding the City’s motion. Under *Bildisco*, a debtor may reject a CBA, pursuant to §365, if the debtor shows that (1) the collective bargaining agreement burdens the estate, (2) after careful scrutiny the equities balance in favor of contract rejection and (3) “reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution.” *Id.* at 78 (quoting *Bildisco*, 465 U.S. at 526). As noted, the court declined to rule on the application of the *Bildisco* standard to the facts before it. Negotiations continued between the parties. Equally important, the parties failed to fully flesh out the apportionment of certain special-purpose and enterprise funds to labor costs. Without this evidence, the court would be forced to rule based on an incomplete record.

The Vallejo II Epilogue

Over the following months, the parties resolved most of the remaining issues by agreement. In late August 2009, the City and the IAFF agreed to a consensual rejection of the CBA, but the City and the IBEW remained at odds. On Aug. 31, 2009, the bankruptcy court filed its findings of fact and conclusions of law (Rejection Order) with respect to the IBEW CBA. Ultimately, the City satisfied its burden for rejecting this union contract.

The most remarkable aspect of the Rejection Order is the court's observation that its findings regarding chapter 9 eligibility, standing alone, "justify granting [the rejection] motion." Rejection Order at 4. Eligibility often presents the most highly litigated aspect of a chapter 9 proceeding. In the wake of *Vallejo II*, litigation of this issue likely will skyrocket. From the perspective of unionized municipal employees whose compensation and benefits are governed by CBAs, the bankruptcy will be won or lost within the first few months of the case.

Insulated from market forces, unionized labor placed an increasing strain on the City's coffers. Labor costs swallowed up approximately three-quarters of the City's total expenditures from its general fund. The bankruptcy court noted that mandatory salary increases and health care costs were expected to increase significantly under the existing IBEW CBA. *See id.* at 14-18. Denying the City's motion to reject this contract would compel the City to pay an *additional* \$500,000 in FY 2009-10 to IBEW employees. *Id.* at 25. Prior to this increase, compensation under the IBEW CBA exceeded market rates. *Id.* at 26.

The court found that "[a]bsent rejection of the IBEW CBA, it is unlikely that the City will be able to implement a viable plan of adjustment and emerge from bankruptcy." *Id.* Unlike the other unions, the IBEW did not agree to a salary reduction under interim agreements. *Id.* at 20. Neither the economics nor the equities weighed in favor of denying the City's motion.

At the same time, post-filing economic factors crippled the City's ability to fund these increasing costs. When the City filed its motion on June 30, 2008, it forecasted a general fund deficit approaching \$17 million. *Id.* at 6. In November 2008, the City adopted an amended FY 2008-09 General Fund Budget due to a \$3.2 million revenue decline. This shortfall resulted from a sharp drop in property taxes, decreased sales tax revenues associated with retail store closures and decreased license fees and miscellaneous taxes. *Id.* at 8-9. Moreover, a significant private source of municipal funding filed for bankruptcy, leaving it unable to pay the assessment due in December 2008. *Id.* at 11. The best that the City could hope for in FY 2009-10 were flat revenues; the county assessor painted a much grimmer picture. *See id.* at 12. To make matters worse, the City no longer could ignore the capital expenditures it deferred in its attempts to control its deficit. *Id.* In short, the revenue sources that funded labor costs continued to fall as the bankruptcy case progressed.

The argument that the City did not make "a reasonable effort to negotiate a voluntary modification of the IBEW CBA" found no support. The IBEW claimed that the City fell short in negotiating differently with each of the unions. The court noted that the differences in both the labor markets and the terms of the applicable CBAs justified different treatment in negotiations. *Id.* at 22. Since labor costs comprise

such a large portion of the City's creditor body, the court likewise dismissed the IBEW's argument that the City "unfairly target[ed]" the IBEW as compared to other creditors. See *id.* at 22-23. In light of the ongoing negotiations between the City and the IBEW, both before and after the commencement of the bankruptcy case, the court concluded that the City satisfied its burden regarding "reasonable efforts to negotiate." *Id.* at 27.

Conclusion

Whether the rejection of the IBEW CBA under the standard articulated in *Vallejo II* will be an isolated blip or the new face of chapter 9 proceedings remains to be seen. Likewise, the City of Vallejo's case has not sufficiently unfolded to reveal the full impact of the court's reasoning on any contemplated modification or rejection of public pension plans. To the extent that public pension plans themselves constitute executory contracts, it logically follows that these plans may be rejected in a chapter 9 proceeding pursuant to §365 of the Bankruptcy Code. The termination of private defined benefit pension plans is governed by the Employee Retirement Income Security Act of 1974 (ERISA). By contrast, ERISA supplies no comparable mechanism for terminating public pension plans. The appeal filed by the IBEW on Sept. 10, 2009, leaves the resolution of this significant issue for another day.

1. In some respects, the prefatory phrase contained in California's enabling statute rests on shaky constitutional grounds. See Cal. Gov't Code §53760. One potential way to avoid the constitutional problems suggested by the bankruptcy court is to apply the prefatory language quoted above solely to the ability of a local public entity to file a bankruptcy petition, as opposed to limiting, by state legislation, the powers that a local public entity may exercise once it filed a petition. Under the court's reasoning, the latter interpretation violates the three constitutional provisions previously noted.

