

Bankruptcy and Public Finance Advisory: Bankruptcy Judge Rules that City of Vallejo Can Void Union Contracts

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The nation's cities, towns and other municipalities have certainly not been immune from the effects of the economic downturn. An option that may be available to municipalities facing dire financial circumstances is to file for bankruptcy under Chapter 9 of the Bankruptcy Code, which allows an eligible municipality to adjust its debts in a bankruptcy case. Chapter 9 is in many ways similar to Chapter 11 of the Bankruptcy Code. However, it has some significant constitutionally based differences due to the Tenth Amendment of the United States Constitution, which protects state sovereignty. As a result, while many of the provisions of Chapter 11 apply in Chapter 9, many do not. Since bankruptcy filings under Chapter 9 are exceedingly rare compared to filings under Chapter 11, each decision under Chapter 9 takes on great importance.

A recent decision¹ by a California bankruptcy judge may make Chapter 9 a more viable alternative for struggling municipalities. In this case, a bankruptcy judge confirmed that a Chapter 9 debtor has the authority to reject its existing collective bargaining agreements as part of its effort to adjust its debt, and that state law that might have further limited the municipality's negotiating flexibility did not apply. As the amounts due under such agreements are often a large part of a municipality's financial obligations, the ability to modify such claims is significant.

Rejecting Union Contracts in Bankruptcy

Section 365 of the Bankruptcy Code allows a bankruptcy trustee or a Chapter 11 debtor-in-possession to assume or reject most types of "executory contracts." "Executory" means that both parties still have remaining obligations under the contract. For most contracts, the bankruptcy court will authorize the debtor's decision to assume or reject a particular contract provided that the debtor can show that reasonable business judgment supports the rejection. Unexpired collective bargaining agreements qualify as executory contracts subject to rejection under section 365.²

Until the Supreme Court's ruling in *NLRB v. Bildisco & Bildisco*,³ courts struggled to determine whether and how the "business judgment" standard should also be applied with respect to the rejection of a collective bargaining agreement. In *Bildisco*, the Supreme Court held that a labor agreement can be rejected under section 365 if it burdens the bankruptcy estate, the equities favor rejection, and the debtor made reasonable efforts to negotiate a voluntary modification without any likelihood of producing a prompt and satisfactory solution.

In response to the *Bildisco* decision, Congress enacted section 1113 of the Bankruptcy Code. Section 1113 provides that the court “shall” approve a debtor’s motion to reject a collective 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.

By adding this provision to the Bankruptcy Code, Congress ensured that a debtor could not unilaterally rid itself of its labor obligations. *Importantly, section 1113 is not applicable in Chapter 9 cases.*

As a result, a court faced with a municipal debtor seeking to reject a collective bargaining agreement faces a basic question: does the business judgment standard under section 365 as amplified by *Bildisco* apply, or does some alternative state law regime apply?

Judge Holds Section 365 Standard Applies in Chapter 9 Case

The city of Vallejo, California moved to reject its collective bargaining agreements with its unionized police officers, firefighters, electrical workers and administrative and managerial personnel. Vallejo and two of the unions ultimately reached a settlement. As to the other two unions, Vallejo argued that the standard in section 365 and *Bildisco* apply to a Chapter 9 case. The unions argued that the more restrictive state law applied.

In holding that section 365 and *Bildisco* apply to Chapter 9 cases, the judge reasoned that states have the ability to authorize whether its municipalities may access Chapter 9. Since California does authorize its municipalities to file Chapter 9, it “must accept Chapter 9 in its totality” rather than cherry-picking some provisions and discarding others. Accordingly, if a municipality is authorized to file a Chapter 9 petition, the municipality “is entitled to fully utilize [section 365] to accept or reject its executory contracts.” The judge further ruled that any California law that purported to superimpose California labor laws onto section 365 would be unconstitutional by operation of the Bankruptcy Clause, the Supremacy Clause, and the Contracts Clause of the U.S. Constitution.

Potential Impact of Ruling

This decision has the potential to have a large effect nationwide if it is upheld. In these troubling economic times, it is safe to assume that several cities teetering on the brink of financial disaster have been watching the Vallejo case closely. This decision gives cities a greater bargaining position with unions which, perhaps prior to the Vallejo decision, refused to concede to any

modification of labor contracts. This improves a municipality's bargaining position, making Chapter 9 bankruptcy a much more attractive option.

Endnotes

¹ *In re City of Vallejo*, Case No. 08-26813-A-9 (Bankr. E.D. Cal. March 13, 2009).

² *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 521-22 (1984).

³ 465 U.S. 513 (1984).

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