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Fiscal Insolvency Under AB 506: Death by a Thousand Meetings

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On February 28, 2012, following two declarations of fiscal emergency, the City of Stockton became the first city to enter into pre-bankruptcy mediation under Assembly Bill 506.[1] Signed into law by Governor Brown on October 9, 2011, AB 506 requires a public entity to participate in a neutral evaluation process with its creditors before petitioning for bankruptcy protection. Prior to the bill's passage, a public entity in California could seek bankruptcy protection at its own discretion with no prior procedural steps. While many factors led to Stockton's entry into the AB 506 process, retirement and labor costs played a significant role in the city's declarations of fiscal emergency and its ultimate entry into the AB 506 process. After Stockton, Mammoth Lakes quickly followed suit, and other cities have asked how the AB 506 process works and how it could affect labor relations.

The purported goal of AB 506 is to make filing for bankruptcy protection "a last resort," one that is "instituted only after other reasonable efforts have been made to avoid a bankruptcy filing or otherwise appropriately plan for it."[2] The bill creates a process for the municipality and its creditors to engage in "reasonable efforts" to resolve their disputes outside of bankruptcy or, if the disputes cannot be resolved, to begin negotiations that will continue in the bankruptcy action.

Although the requirements of AB 506 are not onerous and may provide the municipality with some benefits, a municipality needs to understand the limitations of the law and how creditors (including labor unions) may exploit those limitations. Furthermore, a municipality that wants to impair its obligations under collective bargaining agreements, either within or outside of the AB 506 process, must understand its negotiation obligations and the time involved to fulfill them.

This article outlines the parameters and limitations of the AB 506 process: the roles of unions and retirees, coordination with other state law rights and obligations (such as declarations of fiscal emergency and the duty to bargain under the MMBA), and the impact of factfinding pursuant to AB 646.

Overview of State Laws Allowing Municipalities to File for Bankruptcy

Federal municipal bankruptcy law arose out of the financial crisis of the Great Depression, when in 1934 Congress enacted chapter 9 of the federal Bankruptcy Code. Since then, fewer than 500 municipal bankruptcy petitions have been filed.[3] The most significant petitions filed recently have been Harrisburg, Pennsylvania; Vallejo, California; and Jefferson County, Alabama.

Under chapter 9, discussed below, a municipality cannot file for bankruptcy protection unless state law authorizes it to do so. Until the passage of AB 506, California provided broad authorization that granted all California public agencies blanket approval to seek bankruptcy protection.

Other states take a variety of approaches in addressing whether local governments can file for protection under chapter 9 bankruptcy. Only Georgia specifically prohibits municipalities from claiming chapter 9 protections.[4] In at least 20 other states, no statute specifically provides authorization. Some states permit bankruptcies but require that the municipality or a separate commission declare a fiscal emergency prior to filing.[5]

Municipal Bankruptcy Under Chapter 9

Chapter 9 applies solely to public agencies. According to the U.S. courts, the purpose of chapter 9 is to "provide a financially distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts."[6] Unlike bankruptcy protection under chapters 7 or 11, a public agency cannot be shuttered entirely or have its assets liquidated. Under chapter 9, the bankruptcy court has limited ability to interfere with the day-to-day activities of the public agency.[7] For example, a public agency may hire consultants and other professionals without approval from the court. The court can review these fees only as part of the public agency's plan of adjustment and may opine only on the reasonableness of the fees.[8]

In order to file for relief under chapter 9, the public agency must not only be authorized to do so, but must be insolvent[9] and desire a plan to readjust its debts. Additionally, the public agency must either have obtained some agreements with a majority of its creditors, attempted to negotiate in good faith with these creditors unless such negotiations are impracticable, or have believed that the creditor may attempt an avoidable transfer under the Bankruptcy Code.[10]

History of Municipal Bankruptcy Filings in California

Although California has allowed municipalities to file bankruptcy for over 70 years, not many have sought such protection. Only three general government agencies in the state have filed for protection during that time: Orange County, Desert Hot Springs, and Vallejo.[11]

Orange County's highly publicized 1994 bankruptcy led many to question whether the state should be more active before allowing financially distressed municipalities to seek bankruptcy protection. The California Law Revision Commission, an independent state agency that assists the legislature and governor by recommending reforms to California law, recommended that the legislature revise California's municipal bankruptcy statute to conform its definitions to those used in federal bankruptcy law. In 2002, the commission's proposed changes were enacted as law under SB 1323 (Ackerman).[12] The commission did not recommend the legislature enact any substantive policy changes or pre-conditions.

In contrast, as a result of the Orange County bankruptcy, the legislature debated substantially revising California law to establish state oversight for public agency bankruptcies. Senate Bill 349[13] would have established a "Local Agency Bankruptcy Committee," which would have determined whether a municipality met the requisite criteria to file

a chapter 9 bankruptcy petition.[14] Though this bill passed the legislature, it was vetoed by then-Governor Pete Wilson, who stated, “State denial of access to Chapter 9 may create the implication that the state has assumed responsibility for the debts of distressed municipality.”[15] The law remained in effect without any significant modification.

Thereafter, legislation lay relatively dormant until the City of Vallejo’s declaration of bankruptcy in 2008 brought on a new demand for revisions to the law.[16] Labor organizations spearheaded a change because of the experience with Vallejo’s bankruptcy filing.[17]

Vallejo was arguably the first structural municipal bankruptcy in California in that the move was driven largely by rapidly increasing personnel costs, whereas the County of Orange bankruptcy rested on poor investments, and other bankruptcies (such as Mammoth Lakes) have stemmed from litigation awards.[18] In an effort to stave off bankruptcy, Vallejo engaged its labor organizations in discussions to modify its existing collective bargaining agreements.[19] When that failed, Vallejo filed for bankruptcy protection and filed motions to reject all of its collective bargaining agreements. The unions strongly opposed Vallejo’s actions and filed eligibility challenges asking the courts to reject Vallejo’s bankruptcy petition.

While the bankruptcy filings were pending, Vallejo continued to meet and confer with its four labor organizations, but without any real progress. To maintain solvency, Vallejo unilaterally implemented changes to wages, hours, and other terms and conditions of employment under bankruptcy pendency plans.[20] Though it ultimately reached agreements with its police and managerial unions, Vallejo initially was unsuccessful in renegotiating terms and conditions with its fire and general employee unions.[21] The court rejected the unions’ objections to Vallejo’s bankruptcy petition and approved the city’s rejection of the fire and general employee collective bargaining agreements. [22] This set Vallejo on a path to negotiate new terms with these unions. At the time, this path included impasse procedures as prescribed in the city’s charter, which culminated in binding interest arbitration.[23]

In response to their concern arising from the events of Vallejo’s bankruptcy, organized labor heavily backed revisions to the law.[24] Assembly Member Bob Wieckowski sponsored AB 506, which labor organizations strongly supported. Wieckowski explained the legislation was in direct response to the Vallejo bankruptcy. He stated, “By bringing all sides together, we were able to reach an agreement that establishes a neutral evaluation process that can save taxpayers’ money and avoid lengthy and expensive municipal bankruptcy cases. That is my No. 1 goal with this bill — to save taxpayers’ money by avoiding bankruptcy.”[25]

AB 506

Governor Brown signed AB 506 on October 9, 2011, and the statute went into effect on January 9. It provides that a public entity can seek federal bankruptcy protection only if either of the following has occurred: (1) the public entity has participated in a neutral evaluation process, or (2) the public entity has declared a fiscal emergency.[26] A public entity[27] is defined as “any county, city, district, public authority, public agency or other entity, without limitation, that is a municipality as defined in Section 101(40) of the United States Code (bankruptcy),[28] or that qualifies as a debtor under any other federal bankruptcy law applicable to local public entities.”[29] The legislation expressly excludes school districts from having to comply with the procedures.[30]

The neutral evaluation process. If a public agency believes that it is, or will be, unable to meet its financial obligations when those obligations become due, the public agency may initiate the neutral evaluation process.[31] The process is comprised of the following steps.

(1) *Notification to interested parties of request for neutral evaluation and response.* To begin the process of neutral evaluation, the public agency must notify all "interested parties" by certified mail of its request.[32] An "interested party" is "a trustee; a committee of creditors; an affected creditor; an indenture trustee; a pension fund; a bondholder; a union that, under its collective bargaining agreements, has standing to initiate contract or debt restricting negotiations with the municipality; or a representative selected by an association of retired employees of the public entity who receive income from the public entity convening the neutral evaluation."[33]

Additionally, "a local public entity may invite holders of contingent claims to participate as interested parties in the neutral evaluation if the local public entity determines that the contingency is likely to occur and the claim may represent five million dollars or comprise more than 5 percent of the local public entity's debt or obligation, whichever is less." [34]

The interested parties must respond to the public entity within 10 business days of receipt of the request.[35] If the interested party fails to respond in that time, it has waived its right to participate in process. [36]

(2) *Selection of neutral evaluator.* The public agency and those interested parties that timely responded must mutually select the neutral evaluator.[37] A neutral evaluator must have training in conflict and alternative dispute resolution, and meet one of the following criteria:

- At least 10 years of high-level business or legal practice involving bankruptcy or service as a United States bankruptcy judge; or
- Professional experience or training in municipal finance and one or more of the following areas: municipal organization, municipal debt restructuring, municipal finance dispute resolution, chapter 9 bankruptcy, public finance, taxation, California constitutional law, California labor law and/or federal labor law.[38]

If the parties are unable to mutually agree on the neutral evaluator, the public agency will furnish the names and resumes of five qualified candidates.[39] A majority of the participating interested parties must then strike up to four names from the list, and the remaining candidate will serve as the neutral evaluator.[40] The legislation does not define what constitutes a "majority of interested parties." Reasonable interpretations could be that it is the majority of the number of interested parties, or it could be that it is the majority of the claims against the municipality. Because most cities have a limited number of bond insurers but several unions, it may be that labor and CalPERS will be the most significant interested parties for AB 506 purposes.

The cost of the neutral evaluator is divided between the public entity and its creditors. The public entity shall pay 50 percent of the cost of the neutral evaluation, and the creditors shall pay the balance.[41] Under the statute, "creditor" is defined more narrowly than an "interested party."[42] Smaller creditors are spared from having to share the cost of what could be an expensive process. However, this creates the first test of cohesiveness between interested parties as they jockey to determine how much each will pay.

(3) *Neutral evaluation process*. The parties must engage in neutral evaluation and negotiations in good faith. Good faith means that the parties will participate in the process with an "intent to negotiate toward a resolution…including the timely provision of complete and accurate information to provide the relevant parties through the neutral evaluation process with sufficient information…."[43] This requires that each representative at the neutral evaluation has the authority to settle and resolve disputes.[44] The new law does not provide for any consequences if an interested party fails to participate in the neutral evaluation process in good faith.

The neutral evaluator does not have the power to impose a settlement on the parties, but instead will "use his or her best efforts to assist the parties to reach a satisfactory resolution of their disputes."[45] In this process, the neutral evaluator appears to work as a mediator, referee, lawyer, and educator, often wearing more than one hat simultaneously. For example, the evaluation process must be voluntary, comprised of "uncoerced decision-making" that allows the parties to make free and educated decisions.[46] Although not an advocate for any party or holding any sort of fiduciary duty towards any party, a neutral provides counsel, guidance, and assistance to the parties in negotiating a "prepetitioned, preagreed plan of readjustment."[47]

The proceedings are confidential unless mutually agreed otherwise by the parties or disclosure is required by a bankruptcy judge in any subsequent eligibility determination.[48]

The neutral evaluator may make "oral or written recommendations for the settlement or plan of readjustment" to a party in private or to all the parties jointly.[49] To that end, the neutral may request documents and other information from the parties that he or she believes would be helpful toward reaching resolution.[50] The documents may include "the status of funds of the local public entity that clearly distinguishes between general funds and special funds, and the proposed plan of readjustment prepared by the local public entity."[51]

(4) *Timing and end of the evaluation process*. The neutral evaluation process shall not last for more than 60 days following the date the neutral evaluator is selected, unless the public agency or a majority of interested parties choose to extend the process for up to an additional 30 days if no agreement is reached.[52] The public agency may also end the process early if the fiscal condition of the agency deteriorates to the point that a fiscal emergency is declared.[53] Of course, the process may also end if the parties reach an agreement even if such an agreement requires the approval of a bankruptcy judge.

Fiscal emergency alternative. If the public agency is unable to proceed through the neutral evaluation process, the public agency may — in the alternative — declare a fiscal emergency prior to filing a petition under chapter 9.[54] The agency must adopt, via resolution by a majority vote of the governing body at a noticed public hearing, a declaration of fiscal emergency.[55] Accompanying this declaration, the governing body must include findings that "the financial state of the local public entity jeopardizes the health, safety, or well-being of the residents of the local public entity's jurisdiction or service area absent protections of Chapter 9" of the federal Bankruptcy Code.[56] Additionally, the resolution of the public agency must include a finding that it will be unable to pay its obligations within the next 60 days.[57] The declaration of fiscal emergency must comply with the open meeting requirements of the Brown Act.[58]

Application of AB 506

Benefits of the law. The requirements of AB 506 do not impose an onerous burden on a municipality. As seen with the City of Vallejo, this process of negotiating with creditors is one in which a financially strapped municipality most likely would have engaged before seeking bankruptcy protection, even without AB 506. Thus, AB 506 turns an ad hoc process into a standardized one. On the downside, it does create a structural impediment to the filing of bankruptcy and increases the time pressure on municipalities, which now have to plan for a minimum of 60 to 90 days before seeking bankruptcy protection. However, this law provides the municipality many benefits as examined below.

(1) *Encourages open dialogue under the guidance of a trained mediator.* The parties will be able to have an open dialogue and exchange of information with the aid of a trained mediator knowledgeable about the limitations of bankruptcy law. At best, the AB 506 process may allow a public agency and its creditors to reach agreements that would avoid bankruptcy.

(2) *Attempts to bring all interested parties to the table.* In the negotiations leading up to the Vallejo bankruptcy, the institutional creditors refused to negotiate with Vallejo until the city could achieve some measure of labor peace and stability by obtaining agreements with the labor organizations, which it was unable to do prior to declaring bankruptcy. Under the neutral evaluation process, the goal is for all interested parties to participate. Nonetheless, an interested party may decide not to respond to a municipality's notice requesting neutral evaluation. However, a non-responsive interested party would have difficulty objecting to the municipality's chapter 9 bankruptcy on the ground that the municipality failed to participate in good faith.

(3) *Completes the legwork required for bankruptcy, should it be required*. Even if the municipality cannot avoid bankruptcy, the AB 506 process will fulfill the requirements mandated under the federal bankruptcy laws, arguably resulting in a quicker and more efficient bankruptcy process. As detailed above, federal law requires that in order for a municipality to file for bankruptcy, the municipality must have negotiated in good faith to obtain the agreement of creditors holding at least a majority of the claims that will be impaired in the bankruptcy. [59] The only exceptions are when the municipality is unable to negotiate with the creditors because such negotiations are impracticable or when the municipality believes the creditor may attempt to obtain a transfer that is avoidable. The negotiations under bankruptcy differ from a public agency's obligations to meet and confer in good faith over matters within the scope of representation as required by the Meyers-Milias Brown Act.[60]

Furthermore, the neutral evaluation process will likely result in the municipality having prepared a plan of adjustment that can be used in the bankruptcy filing. Although the law does not specifically require that the municipality have such a plan ready at the beginning of the evaluation process, the law appears to assume that will be the case.[61] Through the efforts of the neutral evaluator and the negotiation with creditors, the municipality would likely draft a settlement and/or create a plan of adjustment. Thus, by the end of the neutral evaluation process, the municipality will likely have a workable plan that it can use in its bankruptcy filing.

Therefore, engaging in the neutral evaluation process will allow the municipality to have met its negotiation obligation and thus have "its ducks in a row" prior to any bankruptcy filing.

Limitations of the law. The AB 506 process leaves many questions unanswered and may allow parties to exploit these limitations of the law.

(1) *Limited resources of the neutral evaluator*. The neutral evaluator faces a herculean task. The selection of an appropriate neutral will be critical to the potential success of the process. But, it may be difficult to find an evaluator with the breadth of experience and knowledge in the many diverse and complicated areas necessary to handle the challenges that will arise.[62] In all likelihood, bankruptcy attorneys or retired bankruptcy judges will most likely fit the bill, as Judge Mabey has in Stockton. However, even these highly educated and experienced professionals will have blanks in their resumes as municipal bankruptcies are few and far between. Nonetheless, a comprehensive understanding of public finance and public sector labor law is essential if the neutral evaluation process is to be effective.

Furthermore, an issue that is not addressed is whether the neutral evaluator has adequate support. Unlike a mediator who generally is called in to broker a dispute between two parties, this process involves many interested parties with as many disparate views: bondholders, labor organizations, retirees, and other creditors. The amount of data, alone, could be overwhelming without staff or support to make sense of it, analyze it, and then help devise a plan that is acceptable to all parties. If the goal of the neutral evaluation process is to circumvent the need for bankruptcy, then the role of the neutral evaluator is — at the very least — to help draft an acceptable settlement and readjustment plan for getting the public agency out of fiscal distress.

Earlier language in the bill provided for the neutral evaluator to be able to consult with "alternative dispute resolution service providers, the California Debt and Investment Advisory Commission, the California State Mediation and Conciliation Service, the Executive Office for U.S. Trustees, retired bankruptcy judges or other appropriate entities" on matters that were not confidential. The bill, however, did not provide for any compensation for these consultants.[63] Additionally, the limitation on not allowing the neutral evaluator to discuss anything "confidential" would severally limit any benefit that these consultants could provide. The benefit of assistance was stricken from the bill signed into law.

Notably, other states do provide a staff to individuals in roles similar to the neutral evaluator. For instance, in New York State, governing control boards may hire experts or engage professional assistance to help the boards create their own budgets. Under Michigan law, the governor appoints an emergency financial manager who has the right to engage outside professional help, which is typically comprised of four to six full-time staff members with relevant expertise. [64] In California, however, due to economic limitations, it is unlikely that a neutral evaluator will be allowed to hire a staff.

Larger stakeholders will undoubtedly hire their own lawyers, financial advisors, and advocates, which will make the process inefficient and could place the more well-resourced interested parties at an advantage.

(2) *Inability of neutral to sanction parties.* The law does not provide repercussions for a party that fails to engage in the process in good faith. In the earlier version of the bill, the public entity would have been prohibited from filing for bankruptcy if the mediator determined that the public entity "failed to participate in good faith mediation…, which includes… the failure to provide accurate and essential financial information, the failure to reach a settlement with all

interested parties to avert bankruptcy, or evidence of manipulation to delay and obstruct a timely agreement."[65] Furthermore, the mediator could end the mediation if one or more parties did not "participate[] in good faith," and "further efforts at mediation would not contribute to a resolution."[66]

Because the legislature removed that language from AB 506, the mediator has no power to compel the parties to negotiate in good faith. Nonetheless, the municipality will be motivated to do so because failure can be the basis for an objection to its bankruptcy filing.[67] The difficulty, thus, will occur when interested parties fail to negotiate in good faith. It is conceivable that an interested party may engage in delay tactics. If so, neither the evaluator nor the municipality will have any way to curb an interested party's shenanigans.

(3) *Failure to define "majority of the interested parties."* As noted above, although the law provides that the "majority of the interested parties" will make crucial decisions regarding the process, the law does not define the term "majority of the interested parties."[68]

Given that the definition provides that a collective entity, such as a union representing multiple members or an association of retired employees of the public entity, is only an "interested party," an argument that a collective entity by itself can be a majority appears weak. Although this argument is unlikely to prevail, an interested party may attempt to use such an argument to delay the process. As the 60-day process does not begin until the neutral evaluator is chosen, a challenge to who is the "majority of the interested parties," and thus who can choose the neutral evaluator, will put the brakes on the process.

(4) *Difficulty of effective retiree participation.* One of the most significant weaknesses of AB 506 is one that may have no solution: the inability to bind retirees during the process. Retiree medical and pension obligations are some of the most significant unfunded liabilities on the books of many agencies, and reform of retiree medical was a major component of the Vallejo bankruptcy. Although AB 506 does provide for a representative of retirees to participate in the process, it provides no means by which the representative can bind individual retirees. Without that, the AB 506 process has little hope of affecting retiree medical or other post-employment benefit (OPEB) obligations, thus making an ultimate filing of bankruptcy more likely.

(5) *Possible outcomes not addressed*. There are additional scenarios not addressed by the legislation. For instance, during neutral evaluation, what if one interested party and the local entity can settle their differences, but the rest of the interested parties and the local entity are not able to settle? Is it likely that the first interested party to settle may receive more favorable terms than the holdout? If a local entity seeks bankruptcy protection, could the "beneficial terms" given to the settling interested party be set aside as a preference?

How to address these issues in application. In order to maximize the benefits of the AB 506 process and minimize the problems, there are several steps a public entity should take.

(1) *Investigate and compile information.* It is imperative that a municipality immediately begin gathering data on its financial condition and the extent of its debt to prepare for the neutral evaluation. This should happen before the neutral evaluation begins so that the public agency is armed with information to help secure a settlement. Unfortunately, many public agencies facing the prospect of bankruptcy may also lack resources and/or be poorly

managed. With limited resources, it may take some time to gain an accurate understanding of the extent of all the problems, and due to the short timeframe of the neutral evaluation process, time will be of the essence.

(2) *Prepare a settlement plan or plan of adjustment before neutral evaluation begins.* This provides a starting place for negotiations and demonstrates that the city is not only prepared to move towards bankruptcy protection if necessary, but also presents to the neutral evaluator — and to the public — a picture for its future solvency. Given the short time table in the neutral evaluation process, it would take a significant amount of time to work with the interested parties in crafting a settlement plan that in all likelihood will only address the "low hanging fruit." Additionally, attempting to craft a settlement plan with the interested parties may give those with the loudest voice the greatest amount of control over the process. The plan of adjustment should address both short-term needs and long-term goals so that the municipality can balance its budget and remain solvent in the near future.

Parallel Negotiations Before Contract Impairment

Unfortunately, the requirements set out under AB 506 and the Bankruptcy Code are not the only obstacles a municipality must manage prior to modifying its obligations under a collective bargaining agreement. As described below, additional requirements are mandated by a number of sources, including case law regarding contract impairments under fiscal emergency declarations, a new law that requires mandatory factfinding for impasses, and impasse procedures contained in certain city charters. Not only must municipalities be aware of these additional hurdles, they must consider the additional time necessary to complete these requirements.

Contract impairment under the fiscal emergency resolution. Prior to the enactment of AB 506, a fiscal emergency declaration by California public entities was especially significant because it allowed local governments to revisit otherwise fixed contracts, such as collective bargaining agreements under the Meyers-Milias-Brown Act.[69] Although both the United States and California constitutions prohibit government from enacting legislation that changes or impairs contracts, courts have long recognized that this prohibition is subservient to government's power "to protect the lives, health, morals, comfort and general welfare of the public," i.e., a public agency's inherent police powers.[70] A declaration of fiscal emergency enunciates the reasons for triggering this police power so that local governments can impair contracts.

The declaration of fiscal emergency under AB 506 appears to be very different than the declaration of fiscal emergency that stems from a public agency's inherent police power. Under AB 506, the declaration of fiscal emergency is a procedural step on the way to declaring bankruptcy, whereas the common law declaration of fiscal emergency is an exercise of authority allowing legislative impairment of a contract.[71] Under the common law, a public agency has wide latitude in determining what it believes to be a fiscal emergency. However, to comply with the Constitution, the impairment of the contract itself must be appropriately tailored to the emergency it was designed to address, and the result must be reasonable.[72] Legislative enactments that impair contracts, including declarations and resolutions of fiscal emergency, are subject to judicial review. Courts will consider various factors in determining whether or not to uphold a contract impairment.[73] It thus does not appear that the definition of fiscal emergency under AB 506 is intended to alter a public agency's right to declare fiscal emergency under its inherent police power. Instead, it is a separately defined emergency measure limited solely to the "emergency off-ramp" from the AB 506 process.

It is important to note that the criteria under AB 506 are prerequisites to declaring a fiscal emergency, while the courts consider the factors after a fiscal emergency is declared and the contract is impaired. Nonetheless, meeting the AB 506 requirements to declare a fiscal emergency and gain access to federal bankruptcy provisions may ultimately enable public entities to impair contracts under federal law.

Under AB 506, a fiscal emergency declaration and resolution does not independently authorize a public entity to impair contracts but rather acts as a procedural prerequisite that allows it to file for chapter 9 bankruptcy. Accordingly, AB 506 requires that a fiscal emergency declaration meet specific procedural and substantive criteria. For example, the public entity must provide an opportunity for public comment before declaring a fiscal emergency and adopting a resolution by majority vote at a noticed hearing. The resolution must specifically find that financial conditions jeopardize the "health, safety, or well-being of the residents," and that "the public entity is or will be unable to pay its obligations within the next 60 days."[74] A public entity may find it relatively easy to meet these requirements because they are specific and encompass the totality of the requirements to declare a fiscal emergency. Presumably, these hurdles are lower than those imposed by the courts in constitutional contract clause cases because they merely serve as a segue to chapter 9 bankruptcy, which imposes strict guidelines on contract impairments.

In contrast, local governments may face higher hurdles when seeking to impair contracts solely through a fiscal emergency resolution. For example, courts will consider — among other factors — whether the enactment serves to "protect basic interests of society" and has "an emergency justification"; it must also be "appropriate for the emergency."[75] Generally, courts have been less deferential to a public entity's impairment of its own contractual obligations. Some courts will consider an impairment reasonable and necessary only if the public entity shows it did not: "(1) 'consider impairing the…contracts on par with other policy alternatives' or (2) 'impose a drastic impairment when an evident and more moderate course would serve its purpose equally well,' nor (3) act unreasonably 'in light of the surrounding circumstances.'"[76] Ultimately, the vagaries of these hurdles provide both more flexibility and pose a more significant challenge for public entities to uphold contract impairments through a fiscal emergency declaration.

Stockton recently impaired its collective bargaining agreements under a number of emergency declarations. The impairments, which have effectively reduced salaries, imposed furloughs, and curtailed benefits, are being challenged in several venues, including grievance arbitration and by petitions for a writ of mandamus in the superior courts. Though Stockton's contractual impairments impact current employees, any attempt by the city to control its spiraling costs also must address retiree health care. The city recently initiated the AB 506 process.[77]

Contract impairment under bankruptcy proceedings. Even when municipalities have sought bankruptcy protection, they still must negotiate with their labor organizations before rejecting the collective bargaining agreements. In NLRB v. Bildisco & Bildisco,[78] the U.S. Supreme Court held that an employer in chapter 11 could reject a collective bargaining agreement without committing an unfair labor practice — by showing that the agreement was burdensome, that the balancing of the equities favored rejection of the agreement, and that "efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution." Provisions of the agreement cannot be selectively rejected, but must be rejected in their entirety. Once an agreement is rejected, it is "no longer immediately enforceable, and may never be enforceable again." However, even if the agreement is not enforceable, it becomes the basis for the creation of claims.

As the law currently stands, once a municipality files a petition under chapter 9, it may unilaterally modify collective bargaining agreements. The bankruptcy court in In re County of Orange looked to state law to determine whether the county's actions were appropriate. Though the In re County of Orange court concluded that Bildisco applied in chapter 9 cases, the court was not persuaded that municipalities could unilaterally breach collective bargaining agreements without limitations; instead, it required a showing consistent with the fiscal emergency language in the California Supreme Court's decision in Sonoma County Organization of Public Employees v. County of Sonoma. Unlike the court in County of Orange, the court in Vallejo dismissed this rationale, finding that the imposition of state labor law onto 11 USC Sec. 365 would be unconstitutional.[79]

Significantly, Vallejo is factually distinguishable from County of Orange because the city took great pains to negotiate with the unions both prior to and after filing its chapter 9 petition. Orange County unilaterally eliminated employee seniority and grievance rights, whereas Vallejo modified agreements with its unions only after many months of negotiations and mediation. Though the city could have outright rejected the agreements, the modifications it made were circumspect and principally aimed at controlling costs — deferring increases and ultimately reducing wages, eliminating minimum staffing that generated tremendous overtime costs, and implementing a payment schedule to employees leaving city service. These economically driven modifications were substantially different from the modifications made by the County of Orange.

In short, neither Bildisco nor City of Vallejo eliminated the requirement that the parties meet and confer in an attempt to resolve disputes prior to unilateral modifications. Chapter 9 contains requirements that the municipality engage its creditors — including its unions — in negotiations at all stages of the process. This requirement is found in the Bildisco decision: a municipality "should continue to try to negotiate with key creditors to avoid [bankruptcy], and it should carefully document what steps are taken to reach agreement." Under the protection of the automatic stay in bankruptcy, any "unfair labor practice" with regard to negotiations is not heard by the Public Employment Relations Board, but is brought to the bankruptcy court by an adversary.

Impasse procedures under state law and local rule. A recent piece of legislation will likely impact municipalities that need to impair their contracts outside of the AB 506 process. AB 646 institutes a new mandatory impasse process for negotiations conducted under the MMBA. If a local public employer and its employee organization are unable to reach agreement in negotiations, the employee organization (but not the employer) "may request that the parties' differences be submitted to a factfinding panel." The panel consists of a union member, a management member, and a neutral chairperson appointed by PERB — typically someone with interest arbitration or factfinding experience. The factfinding panel can ultimately make recommendations but does not have final and binding authority.

Although some local charters provide for interest arbitration as a method for resolving disputes, most public agencies are not subject to interest arbitration. This law changes the landscape for public employers covered by the MMBA that do not already have binding interest arbitration. It imposes on local government a requirement for factfinding in any instance in which an employee organization requests it, regardless of the historic process that local agencies and employee organizations have agreed to and followed.

The factfinding panel hears evidence on the negotiation issues in dispute, provides findings, and recommends terms for settlement. The panel conducts an investigation, holds hearings, and may issue subpoenas for those purposes. Once the hearing is concluded, the AB 646 panel issues findings. It is not clear whether the factfinder must make findings on an issue-by-issue basis or choose between the proposals submitted by the parties. An employer may not unilaterally impose its last best offer until after holding a public hearing, and no earlier than 10 days after receipt of the findings and recommendations.

AB 506 and AB 646 were signed into law on the same day; however, neither law addresses the impact of the other. Given the fact that the legislature passed these two bills at essentially the same time, it would be reasonable to assume that it could have limited the scope of AB 646 so as not to apply to the AB 506 process. Such an exemption was not made.

The most sensible way to interpret AB 646 in light of AB 506 is to understand that AB 464 provides for expanded impasse procedures prior to implementation of a last, best and final offer. For example, in the City of Vallejo, once the bankruptcy court approved the rejection of the agreement with the fire union, the parties — undoubtedly at impasse — triggered the city's charter impasse procedure. The city and the fire union engaged in mediation and interest arbitration pursuant to the then-existing terms of the city charter. A new agreement was reached.

Similarly, once an agreement is rejected by the bankruptcy court, or expires naturally, AB 646 requires factfinding if impasse occurs when it comes time to adopt a new agreement. Moreover, given the timelines of many negotiations (occurring prior to the adoption of the next fiscal year's budget), it is conceivable that negotiations over successor bargaining agreements may occur simultaneously with the AB 506 process. While the parties could certainly agree to defer bargaining until after the completion of the AB 506 process, doing so puts the agency at risk if the governing body ultimately determines that it is unnecessary to proceed to chapter 9. Therefore, absent a specific agreement addressing this issue, we recommend negotiating concurrently with the AB 506 process.

Conclusion

Many municipalities are experiencing severe economic problems as a result of the financial crisis of the last few years. When faced with potential insolvency, a municipality must comply with AB 506 and a number of other laws regarding contract impairment. AB 506 may provide the municipality some relief if the interested parties and the municipality are able to settle their disputes, or allow the municipality to adequately prepare for bankruptcy. However, AB 506, AB 646, and other laws may simply create a number of hoops through which the distressed municipality must jump. Municipalities must plan for them accordingly.

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NOTES:

[1] AB 506, 2011-12 Leg. (enacted Oct. 9, 2011), codified at Gov. Code Secs. 53760, 53760.1, 53760.3, 53760.5, and 53760.7.

[2] AB 506 Sec. 1(a)(2011).

[3] Sakai and Ng, "We're Bankrupt…Now What?" CPER No. 199, pp. 7-14 (May 2010), quoting U.S. Courts Bankruptcy Basics found at http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx.

[4] Ga. Code Ann. Sec. 36-80-5.

[5] E.g., Ohio (Ohio Rev. Code Ann. Sec. 133.36 [upon the Commission's declaration of fiscal emergency]) and Illinois (50 ILCS Sec. 320 [for municipalities with populations less than 25,000, upon the Commission's declaration]).

[6] http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx.

[7] 11 USC Sec. 904. Municipal bankruptcies must conform to the requirements of the 10th Amendment of the United States Constitution and avoid the potential that the federal government will substitute its control over the affairs of the state and the elected officials of the public agency. The public agency continues to maintain its ability to raise revenue and make expenditures as it deems appropriate.

[8] Sakai et al., "We're Bankrupt…Now What?" CPER No. 199, supra, quoting U.S. Courts Bankruptcy Basics found at http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx.

[9] Insolvency as defined in 11 USC Sec. 101(32)(c) is generally not paying debts as they become due or inability to pay debts as they become due.

[10] 11 USC Sec. 109(c).

[11] Since 1991, 24 local public entities have filed for bankruptcy protection in California, the majority of which have been small healthcare districts.

[12] Bill Analysis of AB 506, Third Reading, as amended on Aug. 31, 2011, Senate Rules Committee [2010-11 Reg. Sess.], at 4 ("Bill Analysis").

[13] SB 349, 1995-96 Leg. (Kopp).

[14] SB 349, 1995-96 Leg., as passed by the legislature and vetoed by governor, (1996), available at http://www.leginfo.ca.gov/pub/95-96/bill/sen/sb_0301-0350/sb_349_bill_960831_enrolled.pdf.

[15] Bill Analysis, at 10.

[16] Hearings on AB 506 Before the Senate Governance & Finance Committee, 2011-12 Leg. (July 6, 2011).

[17] In the "Background" section to the bill, it is noted that "[t]he City subsequently asked the bankruptcy court for permission to reject collective bargaining agreements with four unions representing city employees." (Bill Analysis of AB 506, Third Reading, as amended on Aug. 31, 2011, Senate Rules Committee [2010-11 Reg. Sess.], at 5 ["Bill Analysis"]).

[18] Henry N. Pontell and William K. Black, "Orange County Voices: The Financial Lessons Not Learned," Los Angeles Times (February 23, 1995) found at http://articles.latimes.com/1995-02-23/local/me-35080_1_orange-county.

[19] See Charles D. Sakai, et al. "We're Bankrupt…Now What?" CPER No. 199 (May 2010), at 10.

[20] Sakai, supra, note 28, at 10. The unilaterally implemented changes included reduced wages, elimination of minimum staffing requirements, and a deferred payment plan for employees separating from the City of Vallejo.

[21] Sakai, supra, note 28, at 11.

[22] Bill Analysis, supra, note 28, at 5.

[23] Since that time, Vallejo citizens voted to remove binding interest arbitration from the city's charter.

[24] One assembly bill, AB 155 (Mendoza), would have required the approval of a state commission or the completion of a state audit prior to the public agency being able to file with the bankruptcy courts. That bill died on the Senate floor during the 2009-10 session. See Hearings on AB 506 Before the Senate Governance & Finance Committee, 2011-12 Leg. (July 6, 2011).

[25] Press Release, California State Democratic Caucus, "Assembly Sends Wieckowski Municipal Bankruptcy Bill to Governor Press Release" (Sept. 9, 2011), available at Assembly Member Bob Wieckowski's website, http://asmdc.org/members/a20/newsroom/press/item/2681-assembly-sends-wieckowski-municipal-bankruptcy-bill-to-governor. Assembly Member Wieckowksi is a bankruptcy attorney representing California's 20th district (Fremont, Newark, Union City, and Milpitas). He previously served as vice mayor of Fremont and as a member of its city council. Wieckowski is currently sponsoring AB 1692, which he terms as a "cleanup bill" for AB 506 and seeks to undo concessions he made in an effort to get AB 506 passed and signed into law. AB 1692 eliminates the timelines for mediation and "allows the neutral evaluator to request and control the process of an independent investigation in an effort to obtain meaningful financial information and explore other areas of recovery." Hearings on AB 1692 As Amended Before the Assembly Committee on Local Government, 2011-12 Leg. (April 25, 2012).

[26] Gov. Code Sec. 53760.5.

[27] Public agency and public entity are used interchangeably in this article.

[28] Note: Under the 101(40) of the Bankruptcy Code, the term "municipality" means "political subdivision or public agency or instrumentality of a State."

[29] Gov. Code Sec. 53760.1(f).

[30] Id.

[31] Gov. Code Secs. 53760 et. seq., as amended.

[32] Gov. Code Sec. 53760.3(a).

[33] Gov. Code Sec. 53760.1(e).

[34] Id. (emphasis added).

[35] Gov. Code Sec. 53760.3(b).

[36] Gov. Code Sec. 53760.3(c).

[37] Id.

[38] Gov. Code Secs. 53760.3(d)(1) & (2).

[39] Gov. Code Sec. 53760.3(c)(2).

[40] Id. Once chosen, the neutral evaluator must make an inquiry to determine whether there are any facts a reasonable individual would consider likely to create a potential or actual conflict of interest. The parties can remove the neutral evaluator during the process.

[41] Gov. Code Sec. 53760.3(s).

[42] A creditor is defined as either of the following: (1) “an entity that has a noncontingent claim against a municipality that arose at the time of or before the commencement of the neutral evaluation process and whose claim represents at least five million dollars ($5,000,000) or comprises more than 5 percent of the local public entity’s debt or obligation, whichever is less”; or (2) “[a]n entity that would have a noncontingent claim against the municipality upon the rejection of an executory contract or unexpired lease in a Chapter 9 case and whose claim represents at least five million dollars ($5,000,000) or comprises more than 5 percent of the local public entity’s debt or obligation, whichever is less.” Gov. Code Sec. 53760.1(b).

[43] Gov. Code Sec. 53760.1(d).

[44] Gov. Code Sec. 53760.3(p).

[45] Gov. Code Sec. 53760.3(i).

[46] Id.

[47] Gov. Code Sec. 53760.3(m).

[48] Gov. Code Sec. 53760.3(q).

[49] Gov. Code Sec. 53760.3(i).

[50] Gov. Code Sec. 53760.3(k).

[51] Id.

[52] Gov. Code Sec. 53760.3(r).

[53] Gov. Code Secs. 53760.3(t)(1)-(5).

[54] Gov. Code Secs. 53760, 53760.5.

[55] Gov. Code Sec. 53760.5.

[56] Gov. Code Sec. 53760.5.

[57] Gov. Code Sec. 53760.5.

[58] See Gov. Code Secs. 54950-54962.

[59] 11 USC Sec. 109(c)(5)(B).

[60] See section below, “Parallel negotiations.”

[61] See Gov. Code Sec. 53760.3(k) (stating that the neutral evaluator may request “the proposed plan of readjustment prepared by the local public entity”).

[62] As noted above, AB 506 requires only that the neutral be a former bankruptcy judge or a person with experience in one or more of the following areas: municipal organization, municipal debt restructuring, municipal finance dispute resolution, chapter 9 bankruptcy, public finance, taxation, California constitutional law, California labor law, or federal labor law.

[63] Senate Governance & Finance Committee, hearing on September 7, 2011 (Lois Wolk, Chair).

[64] In 2011, the Michigan Legislature adopted changes to an existing provision for the appointment of an emergency financial manager that would give the EMF essentially the powers of a bankruptcy judge. There will be a citizen referendum on these changes in November 2012. In the last year, the City of Hamtramck, sought approval for petitioning for bankruptcy protection only to be rejected by the state. Monica Davey, New York Times, “Michigan Town Is Left Pleading for Bankruptcy,” December 28, 2010, A1.

[65] Assembly Committee on Local Government, AB 506 (as amended May 4, 2011, at Sec. 2(b).

[66] Id. at Sec. 38(c).

[67] National Labor Relations Board v. Bildisco & Bildisco (1984) 465 U.S. 513, 536.

[68] In language in an earlier version of the bill, the neutral evaluator could be removed by “a majority of the representatives of the interested parties participating in the neutral evaluation. This language suggests each responsive interested party counts as one, no matter the amount of money at stake in the claim nor the number of claims the interested party represents. Senate Governance & Finance Committee, hearing on September 7, 2011 (Lois Wolk, Chair) (emphasis added).

[69] Gov. Code Secs. 3500 et seq.

[70] Manigualt v. Springs (1905) 199 U.S. 473, 480.

[71] Sonoma County Organization of Public Employees v. County of Sonoma (1979) 23 Cal. 3d 296, 8 CPER SRS.

[72] See Holtzman et al., “Declarations of Fiscal Emergency: A Resurging Option for Public Entities Attempting to Deal with the Current Economic Climate,” California Public Law Journal, Vol. 34, No. 2, Winter 2011 (citing Buffalo Teachers Federation v. Tobe [2d Cir. 2006] 464 F.3d 363, 371).

[73] A few of these factors include, but are not limited to: (1) the enactment serves to protect basic interests of society; (2) there is an emergency justification for the enactment; (3) the enactment is appropriate for the emergency;

and (4) the enactment is designed as a temporary measure. Board of Administration v. Wilson (1997) 52 Cal.App.4th 1109, 1154. (See also Sonoma County Org. of Public Employees v. County of Sonoma [1979] 23 Cal.3d 296.)

[74] Gov. Code Sec. 53760.5.

[75] Board of Administration, supra, 52 Cal. App. 4th at 1154.

[76] Buffalo Teachers Federation v. Tobe, supra, 464 F.3d 362, 371 (quoting United States Trust Co. of New Jersey [1977] 431 U.S. 1, 30-31).

[77] By the time of the publication of this article, it is very likely that the 60 or the 90 day AB 506 process in Stockton will have concluded.

[78] Supra.

[79] Only the federal government is empowered to enact a uniform bankruptcy law. “Incorporating state substantive law into chapter 9 to amend, modify or negate substantive provisions of chapter 9 would violate Congress’ ability to enact uniform bankruptcy laws.” The Supremacy Clause invalidates state laws that “‘interfere with or are contrary to federal law.’” (See generally NLRB v. Bildisco & Bildisco, supra; In Re Vallejo [Bankr. App. 9th Cir. 2009] 408 B.R. 280.) Only the federal government — not the states — may impair contracts. Because Congress is provided the exclusive authority to enact 11 USC Sec. 365, state law is preempted. Rejecting the insertion of state law into the bankruptcy laws, the court concluded that inflexible and conflicting state law must yield to the purposes and the explicit provisions of the bankruptcy law.