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Lessons Learned From a City's Move Towards Bankruptcy: First Look at AB 506 in Action

By Allyson Hauck & Genevieve Ng

Introduction

On April 1, 2013, Judge Christopher M. Klein of the United States Bankruptcy Court for the Eastern District of California ruled that the City of Stockton (also the "City") was eligible for bankruptcy relief under Chapter 9 of the United States Bankruptcy Code.¹ Over the objections of the City's bondholders, who argued that the City was not truly insolvent because it had not cut enough from labor costs and had failed to reduce pension benefits, the court determined that the City met its initial burden of eligibility.²

The court found that the bondholders acted in bad faith by maintaining a "take it or leave it" position: impair the CalPERS contract³ or we will not talk to you.⁴ Importantly, Judge Klein also found that the City and its employee groups had engaged in the required

¹ See Reporter's Transcript of Judge Klein's Findings of Facts and Conclusions of Law, In re City of Stockton, Case No. 12-32118-C-9, United States Bankruptcy Court (E.D. Cal. April 1, 2013) (hereinafter, "Reporter's Transcript"), *opinion issued*, In re City of Stockton, Case No. 12-32118-C-9, 2013 Bankr. LEXIS 2416 (E.D. Cal. June 12, 2013).

² For additional background on municipal bankruptcy, see Charles Sakai and Genevieve Ng, *We're Bankrupt ... Now What?* CPER Journal No. 199 (May 2010) (hereinafter, . For additional information on the AB 506 process, see Charles Sakai & Genevieve Ng, *Fiscal Insolvency Under AB 506: Death by a Thousand Meetings*, CPER Journal No. 206 (2012).

³ The CalPERS contract provides health and retirement benefits to public employees, retirees and their families.

⁴ In re Stockton, 2013 Bankr. LEXIS 2416, at *47.

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Lessons Learned From a City's Move Towards Bankruptcy: First Look at AB 506 in Action

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pre-bankruptcy AB 506 process⁵ in good faith, as it resulted in new memoranda of understandings (“MOUs”) significantly reducing the City’s personnel costs.

Eligibility for bankruptcy relief is just a first step in the long process of Chapter 9, but the court’s ruling is a significant step in that process, and one that validated the difficult decision to declare bankruptcy in the face of service and fiscal insolvency. The City expended tremendous effort, analysis and time - reviewing every possible alternative - before making this decision. Judge Klein’s ruling also recognized the cooperative efforts between the City and represented employees.

Historical and Financial Context of Stockton’s Collapse

Stockton’s problems did not arise overnight. Years of bad management, excessive debt, unsustainable retiree benefits and a pattern of over-market employee compensation created a perpetually imbalanced budget. The City was also hit hard by the “Great Recession.”⁶ Stockton “was ground zero for subprime mortgages,” which saw the median sales price of homes fall from \$422,000 in 2006 to \$140,000 in 2012.⁷ With unemployment at 22 percent and the highest foreclosure rate in the County, the City’s revenues from taxes, sales taxes and other sources plunged.⁸ In 2010, general fund revenues declined by nearly 16 percent from the prior fiscal year.

The City’s revenue decline could not keep pace with the City’s compensation packages for its employees and retirees, as the City’s MOUs provided for generous active employee health care coverage, lifetime retiree

medical, employer funding of the employee portion of CalPERS pension benefit, over-market salaries, and various other benefits and incentive pays. Labor costs accounted for 71 percent of the City’s budget.⁹

In the three years leading up to the 2012 AB 506 process, the City declared fiscal emergencies. Efforts to adopt balanced budgets relied, in part, on renegotiated MOUs or imposition of fiscal emergency measures to eliminate future wage increases, implement furloughs, and make modest changes to the City’s medical plan. In the summer of 2010, with the arrival of Bob Deis as the new City Manager, the City Council adopted an “Action Plan for Fiscal Sustainability” establishing long-term principles to address and reduce the City’s escalating labor and benefits costs.¹⁰ This Action Plan consisted of ten points: (1) reduce or eliminate “additional pay” categories; (2) ensure that side agreements or past practices shall not be binding on the City unless the agreement or practice is approved in public by the City Council; (3) disallow for automatic wage adjustments in labor agreements that are premised on formulae or automatic cost of living inflators; (4) strive to have labor agreements expire at the same time – particularly with public safety unions; (5) require employees to make reasonable contributions toward the cost of health care coverage provided throughout the City; (6) offer one or more additional health care insurance plans, with the City’s contribution based on the lowest cost plan made available by the City; (7) require employees to contribute a fair share of their pension costs; (8) establish vacation use rules that limit the accumulation of vacation time and ensure that the needs of the public take priority and overtime is minimized; (9) regain management rights to supervise, manage, and direct the workforce; and (10) restructure labor agreements to bring overtime obligations in line with the minimums required by the Fair Labor Standards Act¹¹ (“FLSA”).

In Fiscal Year (“FY”) 2010/2011 a \$25 million budget deficit was resolved by staffing cuts and compensation

⁵ See Cal. Gov’t Code § 53790 et seq. AB 506 allows fiscally distressed public agencies to seek federal bankruptcy protection if it 1) engages in a neutral evaluation process with its creditors with the aid of a mediator, or 2) declares a fiscal emergency. For additional information on the AB 506 process generally, see Sakai, *Fiscal Insolvency*, supra note 2.

⁶ *In re Stockton*, 2013 Bankr. LEXIS 2416, at *7.

⁷ 2013 Bankr. LEXIS 2416, at *7, n.3.

⁸ 2013 Bankr. LEXIS 2416, at *7-8.

⁹ 2013 Bankr. LEXIS 2416, at *12.

¹⁰ 2013 Bankr. LEXIS 2416, at *7-8.

¹¹ 29 U.S.C. § 201 et seq.

concessions. However by May 2011, the General Fund deficit for FY 2011/2012 had grown an additional \$37 million. At this point, the City needed major reductions from every unit. City staff prepared two budget options: Plan A and Plan B. Plan A called for layoffs of 253 City employees, while Plan B called for structural changes based on the principles outlined in the City's 2010 Action Plan.

On June 21, 2011, already faced with a service level insolvency where further cuts would have created untenable deficiencies in public safety and other public services,¹² the Council adopted Plan B. This time, through either agreement or imposition based on fiscal emergency, employees took major salary reductions, began contributing the employee portion of PERS, and accepted significant reductions in the City's health plan benefit. Elimination of constant staffing requirements allowed for changes to Fire Department staffing. Changes based on imposed terms and conditions both in 2010 and 2011 resulted in challenges from three unions, culminating in binding arbitration, unfair practice charges before Public Employment Relations Board ("PERB"), and civil lawsuits.

Even these measures were insufficient. The City could not present a balanced budget for the start of FY 2012/2013 and, more significantly, it soon would not have the cash to pay bills, including payroll. The City also forecasted major new deficits for at least the next ten years unless changes were made in its ongoing obligations to debt holders, retirees and employees.

Negotiations and Mediation via AB 506

In February 2012, Stockton authorized initiation of the neutral evaluation process under California Government Code section 53790 et seq., more commonly referred to as AB 506.¹³ To comply with AB 506, the City provided all of its creditors – including represented employee groups, its 2,400 retirees and its bondholders – with a request to begin confidential

good faith mediation. Thereafter, the City and its creditors selected retired bankruptcy court Judge Ralph Mabey (of the United States Bankruptcy Court for the Federal District of Utah) as the mediator.¹⁴

In March 2012, the City provided all employee groups with an initial proposal known as the "ASK."¹⁵ Immediately, the employee organizations formed a coalition (the "Coalition"). Attorneys for the parties negotiated ground rules for mediation, containing a rule that mediation would also count as Meyers-Milias-Brown Act¹⁶ ("MMBA") required negotiations. Because the parties are not exempted from the MMBA meet and confer requirements despite the initiation of AB 506,¹⁷ the City needed to ensure that it would not have to "restart" negotiations following conclusion of the AB 506 mediation.

During AB 506 mediation, Judge Mabey effectuated dialogue and problem-solving between the City and the Coalition.¹⁸ Information request responses were posted on a secured website, which all the employee groups were able to access. The City and Coalition met on approximately 40 occasions, either with the full group or with individual employee organizations to address issues that were organization specific.¹⁹

The vast majority of the major bargaining topics were addressed and tentatively agreed to between the City and the Coalition by the close of the mediation. Thereafter, the City entered into new MOUs with eight of the

¹² Between 2008 and 2011, the City reduced the number of employees by 25 percent. By department, the reduction was as follows:

- 20% reduction in police;
- 30% reduction in fire;
- 38% reduction in public works;
- 46% reduction in library; and
- 56% reduction in recreation personnel.

In re City of Stockton, 2013 Bankr. LEXIS 2416, at *11.

¹³ 2013 Bankr. LEXIS 2416, at *15.

¹⁴ 2013 Bankr. LEXIS 2416, at *17.

¹⁵ 2013 Bankr. LEXIS 2416, at *17, *22.

¹⁶ Cal. Gov't Code § 3500 et seq.

¹⁷ Legislation mandating fact finding under the MMBA was signed into law the same day as AB 506. As discussed in *Fiscal Insolvency Under AB 506: Death by a Thousand Meetings*, the most sensible way to interpret the interplay between AB 506 mediation, the MMBA and AB 646 is to think of AB 506 as a process that is both separate from, but practically speaking, a sort of "substitute" for negotiations. Sakai, *Fiscal Insolvency*, *supra* note 2. If the parties are unable to reach an agreement after substantive mediation, it is highly likely that they are at impasse as defined by the MMBA. The parties would then be able to invoke impasse procedures without additional negotiations. Additionally, all of the findings the City made as to its fiscal condition in preparation in drafting its "Plan of Adjustment" would help support the City's case in fact finding.

¹⁸ *In re City of Stockton*, 2013 Bankr. LEXIS 2416, at *21-22.

¹⁹ 2013 Bankr. LEXIS 2416, at *22.

nine employee groups.²⁰ Importantly, these agreements also included a full waiver of claims from the employee groups that had challenged the City's previous actions. Through these agreements, the City was able to achieve an additional immediate \$5 million in general savings, plus millions in future savings by the changes in business practices and elimination of retiree medical for employees. The other creditors – the bondholders and retirees – did not complete the mediation process.

Conclusions and Lessons Learned

Judge Klein confirmed that the City had done what it could to avoid bankruptcy, but once it couldn't be avoided, the City prepared a comprehensive plan and negotiated in good faith "with everybody that was willing to talk to them."²¹ The key moves made by Stockton in the lead-up to and during the AB 506 process included dedicated staff and consultants coordinating the following:

- An analysis of the City's fiscal and service level solvency;
- A map of the financial reductions required to achieve a sustainable expenditures;
- A plan to engage the City's unions to try to achieve changes through collective bargaining and litigation, if necessary;
- A clear understanding between the City and the unions as to the nature of collective bargaining and mediation meetings;
- A plan to resolve all current and future liabilities, including current waiver of claims; and
- A transparent relationship between the City's labor negotiators and the unions, including producing information for all bargaining units and providing copies of the parties' correspondence on the City's website.

It was only through the cooperative and hard work between the City and its employee groups that Stockton was able to achieve significant savings for the City. Although Stockton is not out of the woods yet – bankruptcy proceedings will take several years to complete – the City, so far, is able to maintain an acceptable level of services for the public, and retain as many employees as possible at sustainable levels for compensation and benefits.

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²⁰ Additional court ordered mediation, conducted by Judge Elizabeth Perris, a bankruptcy judge from the District of Oregon, took place between the City and the bondholders, retirees and the Stockton Police Officers Association - the one union not to reach agreement in the AB 506 process. 2013 Bankr. LEXIS 2416, at *20. A new MOU with the Stockton Police Officers Association was ultimately achieved as part of this process.

²¹ Reporter's Transcript, *supra* note 1, at 592:2-4.