

Chapter 9 May Be Tough to Swallow for Unions, Retirees

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Given the ongoing saga of the bankruptcy proceeding of the city of Detroit—the largest ever municipal debtor to file and be found eligible for Chapter 9 protection—and the possibility of future municipal filings in its wake,¹ restructuring professionals advising public employee unions must be keenly aware of lessons learned from *Detroit* and other recent Chapter 9 cases.

Understanding the key distinctions between the more familiar Chapter 11 bankruptcy process and the relatively unchartered Chapter 9 process, particularly with regard to labor and union negotiation issues and how such negotiations progress prior to and after a municipal filing, is critical to advising public employee unions in restructurings or workouts of struggling municipalities.

While many aspects of the Chapter 9 bankruptcy process are similar to Chapter 11, including such

familiar concepts as the automatic stay, executory contracts, claims bar date, and plan confirmation requirements, glaring differences also abound. Specifically in the sphere of labor- and union-related issues, in Chapter 9 (i) no priority claim exists for wages or pensions owed; (ii) Bankruptcy Code Sections 1113 and 1114, which govern and provide standards for modifying or rejecting collective bargaining agreements (CBAs) and other post-employment benefits (OPEB), are inapplicable; and (iii) no requirement is imposed on a municipal debtor to supply information to its employees or unions before rejecting or modifying pensions or OPEB.

Thus, CBAs (including pension benefits) and OPEB, such as healthcare, life insurance, or other non-pension benefits, may receive no special treatment in Chapter 9. Instead, they generally may be treated and adjusted just like other unsecured obligations, unlike, for example, their treatment under Sections 1113 and 1114 of the Bankruptcy Code in Chapter 11. This could change if a pension or OPEB holder were successfully to argue that such adjustments of pensions or OPEB are unconstitutional, a position that failed in the *Detroit* case at the Bankruptcy Court level.² However, the issue is being litigated on appeal.

Additionally, and critically, Section 109(c) of the Bankruptcy Code ostensibly requires a municipal debtor to negotiate in good faith with its creditors before filing a Chapter 9 petition³ and either (1) reach agreement with a majority

of creditors in each class regarding its treatment in the plan of adjustment (Section 109(c)(5)(A)) or (2) negotiate to impasse over the terms of a plan of adjustment (11 U.S.C. Section 109(c)(5)(B)). However, Section 109(c)(5)(C) exempts a municipality from pre-filing negotiations in circumstances in which negotiations are “impracticable.”⁴

This reality and recent interpretations in *Detroit* and other Chapter 9 cases of the impracticability prong of the municipality’s pre-filing negotiation requirement have effectively rendered the pre-filing negotiation requirement illusory in large municipal bankruptcy cases. Accordingly, public unions and their advisors should be aware that most large municipalities likely can qualify for Chapter 9 without first engaging in any true good faith prepetition negotiations. This differs significantly from the Section 1113/1114 process, under which courts will reject labor modifications proposed without good faith negotiations prior to the start of the 1113/1114 process.

Duty to Negotiate: Chapter 11 v. Chapter 9

At first glance, Chapter 9 bankruptcy does not seem all that different from Chapter 11 regarding the requirement that a debtor negotiate with labor regarding CBA, pension, or OPEB modifications.

The labor negotiation and bargaining process follows a familiar path in Chapter 11. A debtor seeking to modify

continued on page 12

or reject a CBA and/or modify OPEB is required to first satisfy procedural and substantive requirements set forth in Bankruptcy Code Sections 1113 and 1114. Either prior to or subsequent to the filing, but prior to the court considering approval of CBA, OPEB, or pension modifications, the debtor, among other things, must:

- 1 Provide the union with proposed modifications, otherwise known as the debtor's "ask"
- 2 Base its proposed ask on the most complete and reliable information available at the time
- 3 Give the union all relevant information necessary to assist it in evaluating the ask
- 4 Bargain in good faith with the union in attempting to reach mutually satisfactory modifications during the period from the date of the initial ask to the date of the hearing on the proposed modifications
- 5 Meet at reasonable times with the union⁵

Neither Sections 1113 and 1114 of the Bankruptcy Code nor Section 109(c)—which, respectively, require a Chapter 11 debtor to negotiate in good faith before modifying or rejecting a CBA or other retiree benefits and a Chapter 9 debtor to negotiate in good faith with its creditors to establish eligibility for Chapter 9—explicitly defines "good faith" or "negotiation." Nor does the Bankruptcy Code's definitional provision.

Courts have recognized that the duty to bargain in good faith imposed under Bankruptcy Code Section 1113 demands "conduct indicating an honest purpose to arrive at an agreement through the bargaining process."⁶ Accordingly, courts recognize that a "non-negotiable, take-it-or-leave-it proposal" by a debtor fails to comply with the duty to negotiate in good faith required by Sections 1113 and 1114.⁷

Similarly, at first glance, prior to qualifying for eligibility under Chapter 9, a municipality must negotiate in good faith with all creditor classes it seeks to impair, including its labor unions. This requirement exists, in part, because "Congress recognized that municipal bankruptcy is a drastic step and should only be taken as a last

resort" and thus desired prebankruptcy negotiations to try to resolve disputes.⁸

In interpreting Bankruptcy Code Section 109(c), the *Detroit* Bankruptcy Court (citing to a prior recent Chapter 9 decision, *In re Mendocino Coast Recreation & Park Dist.*)⁹ explained that assessing whether good faith negotiations occurred prefiling requires (i) assessing whether the parties "[met] to confer in good faith in attempting to reach mutually satisfactory modifications;" (ii) determining "whether unions have rejected proposals 'without good cause;'" and (iii) balancing of the equities, which requires assessing the conduct of both sides in negotiations.¹⁰

After analyzing these requirements, the court ultimately concluded that Detroit failed to negotiate in good faith with its major creditors, such as its unions and retiree groups, before filing Chapter 9. The court said that Detroit's prefiling proposal "did not provide creditors with sufficient information to make meaningful counter-proposals, especially in the very short amount of time that the City allowed for the 'discussion' period." Moreover, the court found that Detroit failed to conduct any true negotiations,

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with the city having announced that its meetings with creditors were not bargaining negotiations (in the classical sense) and did not provide for back-and-forth discussions.

Nevertheless, the court concluded, following the lead of other eligibility decisions, that Detroit was still eligible for Chapter 9 protection given that negotiations with creditors, such as its unions, were impracticable, due in large part to the sheer volume of creditors involved and the city's inability to bind unions, retirees, and bondholders outside of the Chapter 9 process.¹¹

The *Detroit* court seemingly ignored the fact that outside of bankruptcy, unions commonly negotiate changes to CBAs and other labor benefits that, in practice, affect retiree benefits on a going forward basis and that there are methods, such as class action settlements, to modify even retiree benefits as part of the collective bargaining process. Furthermore, in the Chapter 11 context, debtors often negotiate deals with bond trustees or majority bondholders (despite not being able to bind all bondholders) and then file for Chapter 11 with a prepackaged case or a plan support agreement in tow before hammering down agreements with holdout parties post-filing.

The possibility of significant CBA modifications/changes exists in Chapter 9, but without the extensive ask/negotiation process and information sharing required prior to CBA/OPEB modifications in the Chapter 11 context.

Thus, it is questionable whether negotiations between Detroit and its creditors were truly impracticable. However, admittedly, the Detroit court hewed closely to the trend in the case law that in large Chapter 9 filings good faith negotiations are deemed impracticable and thus excused.

If affirmed on appeal, the upshot of the *Detroit* ruling (and similar Chapter 9 decisions finding impracticability based on the sheer number of creditors and purported lack of retirees or union members with whom to negotiate) is that a municipality can qualify for Chapter 9 without engaging in any real prepetition good faith negotiations whatsoever with its largest creditor classes, including unions. This is critical, given the ability of municipalities in Chapter 9 to modify CBAs, OPEB, and pension

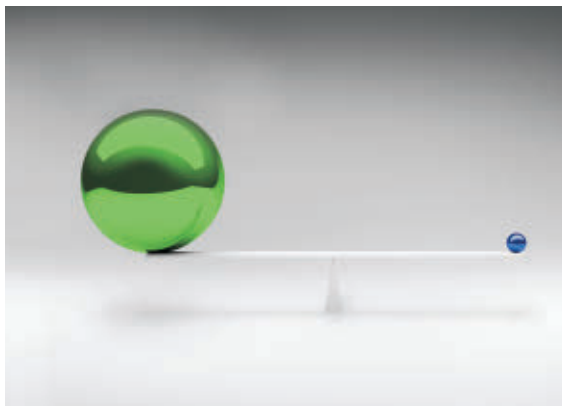
benefits without the protections and required information sharing typically afforded to unions under Sections 1113 and 1114 and applicable in Chapter 11.

Risks to CBAs, OPEB

While the case law remains undeveloped in the Chapter 9 sphere, the likely standard for rejecting or modifying a CBA/OPEB in Chapter 9 is not the 1113/1114 standard, but rather Section 365 of the Bankruptcy Code, as supplemented by the requirements applicable to CBAs set forth by the Supreme Court in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984).¹³

Under the *Bildisco* standard, to reject a CBA in Chapter 9, a debtor still must

continued on page 14



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show that (a) the labor agreement burdens the estate (i.e., continued performance under the agreement impairs the debtor's ability to formulate a plan of adjustment); (b) the equities balance in favor of contract rejection; and (c) "reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution."

While these requirements provide some protection for unions and employees, following the *Bildisco* decision unions succeeded in lobbying Congress to add much more extensive protections to CBA rejection under 1113/1114. Such protections have not been carried over to Chapter 9, however, partially in light of constitutional concerns regarding federal interference with state and local governments' powers to run their municipalities as they see fit. Thus, the possibility of significant CBA modifications/changes exists in Chapter 9, but without the extensive ask/negotiation process and information sharing required prior to CBA/OPEB modifications in the Chapter 11 context.

Finally, with respect to OPEB, given the explicit limitations on the power of Bankruptcy Courts to interfere with the political or governmental powers, property, revenues, or use or enjoyment of income-producing property of municipalities (11 U.S.C. Section 904), those in Chapter 9 cannot be forced or compelled to honor retiree obligations. Thus, litigation to prevent drastic OPEB cuts faces an extreme uphill battle, and in both the *Stockton* and *Detroit* Chapter 9 cases, municipalities succeeded in unilaterally reducing OPEB, including retiree health benefits.¹⁴

Incentives to Negotiate

Given the apparent ability for large municipalities to file for bankruptcy without having truly negotiated prefilings, together with the looser standards applicable to CBA, OPEB, and pension modification/rejection once these municipalities are in bankruptcy, what opportunities remain to avoid a non-negotiated Chapter 9 process?

Given the current landscape, labor, like other constituents, must consider the serious risks it faces in the Chapter 9 process, which do not exist to the same extent in Chapter 11. This may seem counterintuitive because, as noted earlier, municipalities with

many hundreds of creditors may be able to establish their eligibility for Chapter 9 without engaging in any bona fide good faith negotiations. Thus, municipalities can likely enter Chapter 9 without displaying any willingness to negotiate prefilings.

However, it is critical to understand that the damage of a Chapter 9 filing to a municipality's reputation and credit rating may be long-term, if not irreversible, and that the sheer cost of municipal bankruptcy and its drain on city resources remains high and in some cases prohibitive. Thus, municipalities will likely consider prebankruptcy negotiations to avoid Chapter 9—as not every municipality is Detroit.

With this likely prefilings negotiation window, particularly in light of the powers municipalities possess in Chapter 9, all parties should evaluate whether it makes sense to consider making difficult decisions to avoid the costs and even steeper forced cuts that a municipal bankruptcy would likely entail.

Finally, even if a municipality is forced to enter Chapter 9, all hope is not lost. After all, a municipality still needs its workforce to help it emerge from Chapter 9. This is where mediation, a critical aspect of Chapter 9, looms large.¹⁵ Restructuring advisors to unions must prepare for long and difficult mediation sessions, particularly when a municipality has stated goals of cutting labor, pension, and OPEB costs.

To confirm a plan of adjustment, municipalities still must satisfy the "best interests of creditors" test and meet other obligations, including plan feasibility and cramdown requirements, if applicable. The best interests of creditors test has its own unique definition in Chapter 9, namely that creditors that vote against a plan receive as much as they would have if no bankruptcy had been filed and they were left to state law alternatives. Unlike a company in Chapter 11, a municipality cannot liquidate if it cannot pay its debts.

Thus, any unpledged assets of a municipality may play a crucial role in mediation negotiations as a source for increased creditor recoveries, including those of unions and retirees. Ultimately, municipalities in Chapter 9 likely want to get a deal done. Were a Chapter 9 dismissed and the municipality could not satisfy all of its debts, chaos could ensue if thousands of creditors raced to the courthouse.

Given that there really is little alternative to confirming a plan of adjustment in Chapter 9, restructuring advisors should seek to build consensus in as many areas as possible, while remaining keenly aware of the potential eventuality of a cramdown plan, including the risks such a plan would hold for pensions and OPEB. While accepting negotiated cuts to pensions and OPEB may be a potentially difficult pill to swallow, municipal creditors must understand the risks they face in the current reality of the Chapter 9 process. ■

¹ This threat is made more likely given the (i) unfunded pension and other benefit liability of key U.S. cities (see Pew Report, "A Widening Gap in Cities: Shortfalls in Funding for Pensions and Retiree Health Care," available at pewstates.org/research/reports/a-widening-gap-in-cities-85899442341) and (ii) the Bankruptcy Court's determination that Detroit was eligible for Chapter 9 protection and that accrued vested pension benefits may be impaired in Chapter 9 despite explicit protections for such benefits under the Michigan Constitution. See *In re City of Detroit*, Mich. 504 B.R. 97 (Bankr. E.D. Mich. 2013) (explaining that "pension rights are contractual rights . . . subject to impairment in a federal bankruptcy proceeding"). Note that the *Detroit* decision, and specifically the issue of the permissibility of pension impairment in Chapter 9, is currently on appeal before the 6th U.S. Circuit Court of Appeals. See, e.g., *Michigan Council 25 of the American Fed. of State, County and Municipal Employees, AFL-CIO et al. v. City of Detroit, Michigan*, et al. (6th Cir., Case No. 14-1211).

² This argument is particularly appealing in the seven states that currently provide state constitutional pension protection, including Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York. See Center for Retirement Research, "Legal Constraints on Changes in State and Local Pensions," available at crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf; see also manhattan-institute.org/html/ib_25.htm#UxZVO43eswA.

³ Unlike in Chapter 11, where the filing of the bankruptcy petition constitutes the order for relief, "Congress consciously sought to limit accessibility to the bankruptcy court by municipalities." *In re Cottonwood Water & Sanitation Dist.*, 138 B.R. 973, 979 (Bankr. D. Colo. 1992).

⁴ The negotiation requirement is also excused in one discrete circumstance under Bankruptcy Code Section 109(c)(5)(D) when the municipality believes that a creditor is attempting to obtain a prepetition preferential transfer prohibited by Section 547.

⁵ See 11 U.S.C. § 1113(b)(1); see also *In re Pinnacle Airlines Corp.*, 483 B.R. 381 (Bankr. S.D.N.Y. 2012).

⁶ *In re Walway Co.*, 69 B.R. 967, 973 (Bankr. E.D. Mich. 1987) (citing *Cap Santa Vue Inc. v. NLRB*, 424 F.2d 883 (D.C. Cir. 1970)).

⁷ *In re Delta Air Lines*, 342 B.R. 685, 697 (Bankr. S.D.N.Y. 2006).

⁸ *City of Detroit, Michigan*, 504 B.R. at _ (citing *In re Sullivan Cnty. Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 78 (Bankr.D.N.H.1994) and 5 Norton Bankr. L. & Prac. 3d § 90:25 ("It is the policy of the Bankruptcy Code that

a Chapter 9 filing should be considered only as a last resort, after an out-of-court attempt to avoid bankruptcy has failed.”)). 12–CV–02591–JST, 2013 WL 5423788 (N.D.Cal. Sept. 27, 2013).

⁹ *City of Detroit, Michigan*, 504 B.R. at ...

¹⁰ The *Detroit* court relied on prior Chapter 9 Bankruptcy Courts similarly holding that “[t]he impracticality requirement may be satisfied based on the sheer number of creditors involved.” *City of Detroit, Michigan*, 504 B.R. at ...

¹¹ Further exacerbating the lack of protection for union/retiree pension benefits once a municipality enters Chapter 9 is that unlike in the Chapter 11 context, where the Pension Benefit Guaranty Corporation (PBGC) backstops pension obligations up to a certain dollar threshold, there is no PBGC protection for public pension systems.

¹² See *IBEW, Local 2376 v. City of Vallejo (In re City of Vallejo)*, 432 B.R. 262 (E.D. Cal. 2010).

¹³ In *In re City of Stockton, California*, 478 B.R. 8 (Bankr. E.D. Cal. 2012), soon after filing its Chapter 9 case, the city unilaterally reduced OPEB, including retiree health benefits. Certain retirees filed a class action seeking to enforce their contractual rights, but the Bankruptcy Court dismissed the case, holding that: the debtor city could unilaterally reduce the benefits of its retirees and the court was not permitted to enjoin the debtor from implementing the benefit reductions due to the express limitations on a Bankruptcy Court’s power over the debtor in Chapter 9 cases.

¹⁴ In the *Detroit* bankruptcy, the city sought to implement significant OPEB changes. The official committee of retirees appointed



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in the case sought to block this action, but ultimately was forced to settle the issue, and OPEB changes, with certain modifications (the city agreed to provide some additional funding, although nowhere near prepetition levels), were achieved by the city.

¹⁵ Indeed, in several recent large Chapter 9 cases, including *Detroit* and *San Bernardino*, Bankruptcy Courts have appointed mediators at the outset of the case.

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15