

A City's Bankruptcy Redefines Municipal Solvency

By Franklin C. Adams and Robert Tormey

The bankruptcy of the city of Vallejo (*In re City of Vallejo*, Case No. 08-1244) has done much to redefine the key concept of solvency for a municipality. While many restructuring and other legal professionals are familiar with Chapter 11 proceedings and concepts, the filing of bankruptcy by a municipality falls under Chapter 9, and is rare enough that many professionals lack familiarity with the relevant concepts.

Solvency is one of the key differences between Chapters 11 and 9. A corporation may enter the "zone of insolvency" when it either fails to pay obligations on time or when its liabilities exceed its assets. Municipal fund accounting doesn't define a "zone of insolvency" so simply. Municipalities assume continuing tax revenues but do not "capitalize" a revenue stream as an asset on a balance sheet. (The analogue in corporate accounting terms might be "acquired goodwill.") But municipalities don't do acquisitions and don't carry "goodwill." Therefore, it may not be unusual for a municipality to have liabilities that exceed its assets.



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Under Chapter 9, a municipality is insolvent when its financial condition is such that it is generally not paying its debts as they become due or unable to pay its debts as they become due. The first definition refers to the immediate present. However, the second portion of the definition is "prospective," that is, it refers to a condition in the future that can be reasonably certain to occur. Under a ruling in the bankruptcy of Bridgeport, Conn., (*In re City of Bridgeport*, Case No. 129 B.R. 332) a municipality must do more than demonstrate that its revenues will outstrip its expenditures. A municipality must show that, taking into account cash on hand and cash to be received, it will be unable to pay its debts as they become due with reasonable certainty. The municipality is not required to run out of cash and default in order to be deemed insolvent.

The city of Vallejo case was a significant test of the "prospective" definition because it had cash on hand of over \$136 million when it filed for bankruptcy on May 23, 2008. Legal counsel for the city's unions argued that Vallejo could use this cash to address its liquidity needs and therefore, the city failed to meet the qualifications necessary for a municipality to seek Chapter 9 protection.

After careful consideration, Judge Michael McManus determined that the cash in the custody of the city was restricted because most of the cash belonged to committed funds to which Vallejo had strict legal and fiduciary responsibilities. In effect, the \$136 million was not a general fund that the city could borrow from to address its immediate needs.

Consequently, the city was correct in determining that it was prospectively insolvent and that it met the standard of qualifications necessary to seek protection under Chapter 9. The Bankruptcy Appellate Panel of the 9th Circuit unanimously confirmed affirmed Judge McManus's decision in June 2009. (The panel decision was appealed to the 9th U.S. Circuit Court of Appeals, but was withdrawn before a decision could be reached.)

Many aspects of the case remain outstanding and no plan of reorganization in the Vallejo case has been confirmed, although the city council will vote on a new five-year fiscal plan later this month. Yet, the city's success in defending its bankrupt status has put government employees' unions on notice of the risk that their collective bargaining agreements may face in bankruptcy. As a result, California Assembly Member Tony Mendoza (D-Norwalk) introduced AB155.

Under AB155, a municipality would have to obtain approval from the

California Debt and Investment Advisory Commission before filing for bankruptcy. The commission would consist of the state treasurer, the governor or the director of finance, the state controller, two local government finance officials, two state assembly members, and two state senators. AB155 is supported by a number of unions, including the California Professional Firefighters and California Department of Forestry Firefighters Local 2881, both of whom are co-sponsoring the bill.

The California Association of Counties and the California League of Cities are leading the opposition to AB155. By requiring approval by the California Debt and Investment Advisory Commission, unions hope to prevent municipalities from filing for bankruptcy altogether or at least delay the process long enough to give the unions more leverage. Some legal scholars maintain that should AB155 pass it might quickly be challenged on constitutional grounds as an abridgement of a municipality's federal rights under Chapter 9. As the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) is a federal statute, states' authority to restrict rights under BAPCPA may be challenged constitutionally. Earlier this summer it appeared that AB155 was on the fast track for a vote by the legislature. However, its viability is now uncertain.

While the passage of AB155 remains outstanding, the impact of the Vallejo decision is already being felt as municipalities and state governments begin a painful process of "out of court" restructuring. Municipalities, using the new leverage provided by the Vallejo decision, are able to persuade unions that bankruptcy is a real option now, whereas in times past, this strategy was too costly. Many cities have already put in place two-tier systems of wages and benefits where legacy employees' wages are on one scale while new employees' wages and benefits are on a different and more economical scale. The city of Maywood recently outsourced most of its essential services rather than face the specter of bankruptcy.

Similar examples can be found throughout the United States. In March of 2010, the Illinois State Legislature passed Public Act 96-0889, which slashed \$71 billion from future state budgets, requiring newly hired state workers to work years longer than employees in the past to draw full pensions and capping pension payments to a salary at \$107,000 per year. In New Jersey, Chris Christie, a new Republican governor has replaced Democrat Jon Corzine after only one term. Under this new leadership, the New Jersey Legislature passed bills boosting amounts government employees contribute to health care and are limiting pay for new hires. In California, San Francisco Mayor Gavin Newsom has already negotiated with 20 local unions to accept a \$100 million a year cut in



A sign greets visitors to the ferry terminal in Vallejo.

payroll. The city of San Diego is currently suing its own pension system in order to force employees to contribute more to their own retirement benefits.

Municipal restructuring is clearly underway and may not require actual Chapter 9 filings to be successful. Nevertheless, the specter of the Vallejo decision is a factor in the new ability of municipalities to negotiate constructively with their employees' unions. The Vallejo bankruptcy opens the door to a municipality's ability to reject and renegotiate collective bargaining agreements and negotiations that fail to reach a long-term resolution. The signals the court sent seemed to indicate that it is leaning towards allowing these agreements. Clearly, the unions feel they are at more risk on this issue than they have been before, as evidenced by the recent success of two tier collective bargaining agreements. The emphasis on both "prospective" solvency and the importance of fiduciary obligations over restricted funds puts public employees unions at a negotiating disadvantage they have not been in before.

Recent agreements negotiated with various unions should be used as the new benchmark for municipalities looking to work with recalcitrant unions who fail to see the new reality. These agreements present a new starting point that other municipalities should consider in finding relief and negotiating a successful restructuring with their unions before considering Chapter 9.

Reducing Rail Pollution At a Local Level Is Right on Track

By Gideon Kracov and Richard Drury

At first glance, the recent decision by the 9th U.S. Circuit Court of Appeals in *Association of American Railroads v. South Coast Air Quality Management District* appears to be a defeat for Southern California's smog regulators in their efforts to reduce air pollution from locomotives and at rail yards.

But look more closely. The ruling may actually be a victory in disguise. Why? Because the case provides a valuable blueprint for state and local governments on how to control harmful air emissions from these highly polluting sources.

Railroads are major sources of air pollution in Southern California. Eighteen large freight rail yards in California are operated by Union Pacific Corp. and BNSF Railway Co. These rail yard operations spew nitrogen oxides and particulate matter from locomotives, heavy-duty diesel trucks, cargo-handling equipment, refrigerated units and other sources.

They pollute the air with ground-level ozone, an odorless, colorless gas that damages lung and heart tissue, and carcinogenic diesel exhaust. Locomotive emissions alone have been calculated at 158 tons per day of nitrogen oxides and 4.8 tons per day of particulate matter in the state. The South Coast Air Quality Management District estimates that such emissions are its eighth largest local source of nitrogen oxides — greater than all the refineries in Southern California combined.

Air toxic emissions from California rail yards and locomotives also have huge public health impacts. Assessments in San Bernardino and Commerce show that cancer risk caused by the rail yards is far above generally accepted regulatory thresholds. These air toxic "hot spots" significantly impact the health and quality of life for residents in the adjacent communities, including children with asthma and the elderly. That is why the California Air Resources Board insists that "every feasible effort" is needed to "reduce localized risk in communities adjacent" to the state's rail yards.

In 2005, the South Coast Air Quality Management District took on polluting locomotives and rail yards by adopting a series of regulations. The regulations required rail operators to monitor and minimize locomotive idling and to conduct health risk assessments for the largest rail yards.

In response, the Association of American Railroads, BNSF and Union Pacific sued. They claimed the rules were pre-empted and would create an improper patchwork of local regulations in violation of a federal statute, the Interstate Commerce Commission Termination Act (ICCTA). In 2007, a U.S. District Court judge agreed and blocked the South Coast Air Quality Management District rules.

The South Coast Air Quality Management District appealed to the 9th Circuit, arguing that it was acting under appropriate California Health and Safety Code authority to implement the federal Clean Air Act.

In September 2010, however, the 9th Circuit upheld the trial court's decision for the railroads. Writing for a unanimous panel, Circuit Court Judge Susan P. Graber cited a 9th Circuit's earlier opinion, which held that the ICCTA preempts local rules — unless they are rules of general applicability that do not unreasonably burden railroad activity. Judge Graber wrote that the AQMD rules "plainly cannot meet that test."

But, the opinion actually mapped out a path by which such state and local air quality rules can co-exist with the ICCTA.

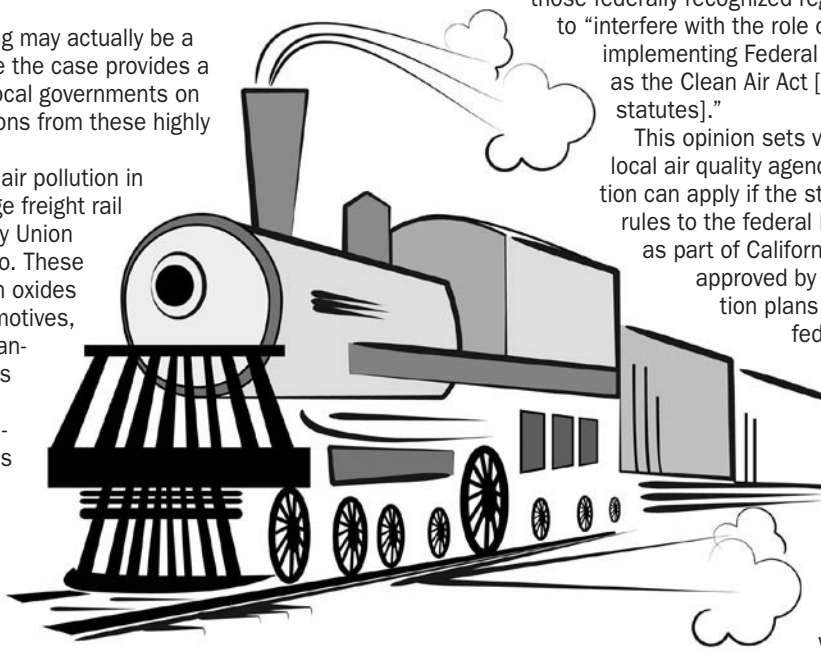
Judge Graber wrote that "to the extent that state and local agencies circulate EPA [Environmental Protection Agency] — approved statewide plans under federal environmental laws, such as 'statewide implementation plans' under the Clean Air Act, ICCTA generally does not preempt those regulations because it is possible to harmonize the ICCTA with those federally recognized regulations." ICCTA is not intended to "interfere with the role of state and local agencies in implementing Federal environmental statutes, such as the Clean Air Act [and the federal clean water statutes]."

This opinion sets valuable precedent for state and local air quality agencies. The principle of harmonization can apply if the state submits its Clean Air Act rules to the federal EPA and then approves the rules as part of California's implementation plan. Once approved by the EPA, the state implementation plans have the force and effect of federal law.

The ruling showed how state and local governments can adopt rules to reduce rail pollution as part of their required state implementation planning duties under the Clean Air Act.

This is no defeat for the Air Quality Management District. In reality, the ruling is a hollow victory for the railroads. Thanks to this precedent-setting opinion,

the air district and local communities can bring tough rail yard pollution measures to the California Air Resources Board and the federal EPA for adoption into the state's implementation plan. In fact, this effort is underway and gaining steam. The railroads should seize this opportunity to invest in, rather than fight, urgently needed environmental improvements at rail yards throughout the state.



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