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Financial Emergencies in Michigan Local Governments

April 2010

Report 362

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MAIN OFFICE 38777 Six Mile Road, Suite 208 • Livonia, MI 48152-3974 • 734-542-8001 • Fax 734-542-8004

LANSING OFFICE 124 West Allegan, Suite 620 • Lansing, MI 48933-1738 • 517-485-9444 • Fax 517-485-0423

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Financial Emergencies in Michigan Local Governments

Summary

Several factors prompt this return to the issue of local government fiscal distress: the current widespread and pervasive nature of the financial challenges facing Michigan's local governments (including governmental units that have traditionally been well-managed), and the severity of the problems facing the City of Detroit. In 1988, the State of Michigan adopted a procedure that allows state intervention in the affairs of local governments that are having a financial emergency. The Local Government Fiscal Responsibility Act, PA 72 of 1990, replaced that 1988 law and provided a process for determining if there is a serious financial problem in a local government, for appointing an emergency financial manager with specified powers and duties, and for resolution of the financial emergency.

Further, the increasing frequency of allusions to municipal bankruptcy or receivership indicates that a review of Chapter 9 of the federal Bankruptcy Code, and clarification of the difference between insolvency and bankruptcy, would be useful.

Definitions

A number of local government officials in fiscally distressed communities have in recent months used the terms "bankruptcy" and "receivership." Use of these words may express the level of concern those officials have, or wish to convey, about the financial condition of their communities, but they are not particularly accurate or appropriate in the context of Michigan local government.

Michigan's general purpose local governments, which are facing extraordinary financial pressures, have a number of options for addressing a deficit between revenues and spending pressures:

- use fund balances accumulated in prior years;
- sell deficit financing bonds to be repaid from future revenue sharing payments;
- seek voter approval for new taxes or increased tax rates within state limits;
- sell assets;
- defer purchases and maintenance;
- lay off employees;
- privatize functions;
- reduce or eliminate services;
- renegotiate contracts to reduce payments; and/or
- consolidate functions with other governments.

At some point, all of these options may be effectively exhausted, or elected officials may be unable to reach agreement on a solution, and at that point, the definitions in the following section of this report become very important.

Cash flow **insolvency** is the inability to meet debts as they fall due. The condition of insolvency may be temporary and does not necessarily lead to state intervention under PA 72 or to bankruptcy. A government that fails to meet a debt is **in default**. Generally, a default is cured by refinancing or renegotiating the debt, but the creditor may seek a **judgment levy** through court action. Under PA 72, if a court orders a judgment levy without the prior approval of the local unit's governing body, then the state treasurer must conduct a preliminary review to determine whether a local government financial problem exists.

The Local Government Fiscal Responsibility Act, PA 72 of 1990, provides a mechanism for state intervention in local governments that incur a financial emergency. (PA 72 also includes provisions relating to school districts: those provisions are outside the scope of this report.) An **emergency financial manager** (EMF) may be appointed under PA 72 of 1990 if a financial emergency is found to exist in a local government and no consent agreement has been negotiated to resolve the emergency. An emergency financial manager assumes the power and duties of the chief executive officer and legislative body, and may reorganize the government structure and renegotiate contracts. PA 72 provides that if an emergency financial manager is unable to resolve the financial emergency, he or she may request approval from the local emergency financial assistance loan board to authorize the local government to proceed under Chapter 9 of Title 11 of the United States Code.

Municipal **bankruptcy** is a specific process available under Chapter 9 that allows the reorganization of cities, villages, townships, and counties, but not states. In spite of the facts that insolvency is one of several conditions necessary to file for bankruptcy under Chapter 9, and that bankruptcy addresses the condition of insolvency, insolvency and bankruptcy are not synonymous. Under Chapter 9, the condition of insolvency is addressed by the automatic stay provision, which stops all collection actions against the debtor at the time the bankruptcy petition is filed. Section 922(d) provides that the automatic stay does not apply to debts secured by pledged special revenues, such as revenue bonds. The federal law provides that states must specifically authorize their municipalities to use Chapter 9. No Michigan municipality has ever filed for bankruptcy, but the process is technically available only under the conditions specified in the Local Government Fiscal Responsibility Act, PA 72 of 1990.

Under federal law, **receivership** is a form of corporate bankruptcy in which the court appoints a receiver to run the company and recoup as much of the unpaid loans as possible, by liquidation if necessary. Receivership may occur when a state or federal regulator places a bank or financial institution under the control of a receiver pursuant to a statute. A court order may place a receiver over property, with or without the consent of the owner, to preserve that property during a lawsuit if there is a danger the property will be removed from the jurisdiction of the court if a receiver is not appointed. A receiver may be appointed over all, or only the contested part, of the property of an individual, partnership, or corporation. The receiver is responsible for administering, conserving, rehabilitating, or liquidating the assets for the benefit of creditors.

Under municipal bankruptcy, no receiver is appointed: the local government develops a plan for adjusting its debts and the court approves or disapproves that plan. The court does appoint a trustee who appoints a creditors committee, but the trustee does not oversee the financial operations of the municipality. The local government itself implements the plan of adjustment under the oversight of the court.

It was only after a court-ordered receivership was established for the City of Ecorse that the Michigan Legislature adopted PA 101 of 1988, the precursor to PA 72 of 1990. There is no state authorization for local government receivership under PA 72 of 1990; although an emergency financial manager may be incorrectly referred to as a "receiver," he or she has different powers than a receiver appointed by a federal court in a corporate bankruptcy.

Six Michigan communities have had emergency financial managers appointed under PA 72 of 1990:

- City of Hamtramck, 2000
- City of Highland Park, 2001
- City of Flint, 2002
- Village of Three Oaks, 2008
- City of Ecorse, 2009
- City of Pontiac, 2009

On February 26, 2010, the governor declared a financial emergency in Benton Harbor.

Potential Alternatives to Current Statutory Approach

Emergency Financial Manager

PA 72 of 1990 has worked reasonably well in those situations where it has been used. It is obvious from past experience, however, that the selection of the individual who is to serve as emergency financial manager is key. It may be that in certain cases (e. g. Detroit) the complex financial and political situation demands a different approach, and that current elected officials or appointees may be the best to serve as emergency financial manager (EFM). If the legislative body were an impediment to implementing financial reforms, appointing a chief executive officer to be EFM would allow that person to relieve the legislative body of authority and implement necessary budgetary and operational changes without their approval. The benefit of this approach is that the state would not be placing an "outsider" with no connection to the community in a position of authority. The problem is that it does not remove local political considerations from the process.

Public-Private Oversight

If it were to be determined that the City of Detroit could not resolve its fiscal difficulties on its own, it might require a specially tailored strategy that accommodates its size, complexity, and political realities, perhaps one similar to the plan developed for New York City in 1975. The establishment of an Emergency Financial Control Board, similar to that created by the State of New York to oversee New York City's financial affairs, may be more appropriate for a city the size and complexity of Detroit. That board could include both city and state officials as well as private sector experts, and could oversee the budget of the City of Detroit and direct implementation of deficit elimination plans. In order to be effective, the board would have to have authority to reject city budgets that contain unrealistic revenues, and to force the city to eliminate deficits as they arise. And in order for the board to be sufficiently well informed to make appropriate decisions, the city's accounting system would have to be improved to the point that financial information is timely and accurate.

State Takeover

Rather than appoint an emergency financial manager or an oversight board for a local government with a financial emergency, the state could designate a state agency that actually exercises financial and operational control of local governments that have financial emergencies. This agency could be authorized to sell notes and bonds guaranteed by defined revenues (including, but not limited to, deficit funding bonds and, with court cooperation, judgment bonds), to raise extraordinary revenues in a designated local unit of government, or to channel special state resources to the unit. The state agency could be empowered, where feasible, to execute contracts transferring all service provision responsibilities to the county or other appropriate unit of government. Although there are constitutional considerations, the state agency could propose and advocate for a merger of local units of government, or propose and advocate for replacing a dysfunctional charter with a model charter.

The proposed agency could be designed to be very intrusive, approving budgets and expenditures, hiring and firing local department heads and employees, negotiating and approving contracts, and managing operations. Or, it could be less intrusive, negotiating a rehabilitation plan and overseeing its implementation by local officials. There could be an established set of threshold events that trigger the state involvement (if, for example, the community's credit rating falls below investment grade or if the local government is unable to meet its operating expenses), or the governor or legislature could be authorized to designate specific local governments for takeover.

Bankruptcy

There is no prohibition in any Michigan statute on the voluntary renegotiation of local government contracts. There is, however, no possible amendment of any Michigan statute that would allow abrogation of local government contracts. Therefore, if the critical problem facing a local government is the inability to afford contractually obligated pay and benefits, and the union(s) refuse to make concessions, no remedy for that problem is possible outside of bankruptcy. Similarly, if the critical problem facing a local government is the inability to make payments on limited tax general obligation debt, and bond or note holders refuse to make concessions, no remedy for that problem is possible outside of bankruptcy

Conclusion

In Michigan, local governments of all kinds are facing financial challenges. In general, these challenges are defined by declining property tax revenues attributable to the real estate collapse and to economic restructuring. In many well managed communities, the decline in revenues has provided an unexpected, and unprecedented, challenge. In other communities with long standing problems, the political environment has not allowed leaders to make necessary reforms.

The state has developed a strategy for addressing local government financial emergencies, but PA 72 of 1990 has not been used in every instance of local government distress. In particular, the state's largest city, Detroit, may require a different approach if it is deemed to have a financial emergency.

While a simple bailout is greatly desired by many local officials, the state is unable or at least unwilling, and the federal government is so far unwilling, to provide this kind of aid. Nor would a bailout address the underlying cause of local government financial distress in Michigan. At this time in our state, a challenge even greater than balancing local budgets with declining revenues and increasing spending pressures, is rebuilding an economic base devastated by the loss of manufacturing and the collapse of real estate values. The most stringent of cost cutting cannot address this fundamental problem.

Financial Emergencies in Michigan Local Governments

Introduction

Fiscal Distress in Local General Purpose Governments

Michigan's general purpose local governments are facing extraordinary financial pressures. These general purpose local governments, which include counties, cities, villages, and townships, depend most heavily on revenues from property taxes and state revenue sharing. Both of these sources have been affected by the Great Recession that officially began in December, 2007. Property values have declined precipitously, in many cases eliminating the gap that had grown between state equalized value and taxable value and reducing the tax payments made by owners. While constitutional state revenue sharing payments to local governments are protected, statutory payments to local governments have been reduced or eliminated as a result of fiscal distress at the state level.

Some local governments have utilized additional tax bases. In the 22 cities that impose a municipal income tax, high levels of unemployment and underemployment caused by the loss of manufacturing, construction, and other jobs have affected income tax receipts. The state's largest and most iconic city, Detroit, also has the most diversified tax base in the state, imposing property, municipal income, utility users' excise, and casino wagering taxes. Factory closings, energy savings initiatives, and population losses affect utility use, and consequently utility users' excise tax payments. Although surprisingly resilient, casino wagering taxes have also been affected by the economic malaise. In addition, a variety of fees, fines, and other local government revenues have been affected by the economic situation. In Detroit, declining tax revenues combined with increasing personnel and other costs, have contributed to an estimated Fiscal Year 2010 accumulated general fund deficit of $326 million on a $1.6 billion budget.

Related to the decline in the property tax base is the decline in the value of public pension funds. Although the value of most funds is smoothed over several years, the recent steep reduction in the value of assets available to make constitutionally guaranteed pension payments contributes to spending pressures. The Governmental Accounting Standards Board (GASB) requirement for disclosure of the present value of promised other post retirement benefits (OPEBs) adds to pressure on the appropriation side. Further, annual cost increases for negotiated employee health care and for retiree health care continue to stress budgets.

Local governments have a number of options for addressing a deficit between revenues and spending pressures:

- use fund balances accumulated in prior years;
- sell deficit financing bonds to be repaid from future revenue sharing payments;
- seek voter approval for new taxes or increased tax rates within charter and state limits; sell assets;
- defer purchases and maintenance;
- lay off employees;
- privatize functions;
- reduce or eliminate services;
- renegotiate contracts to reduce payments;
- consolidate functions with other governments.

In some cases, however, local government officials have not been able to control expenditures or increase revenues in a manner sufficient to avoid deficits. When strategies to balance revenues and expenditures fail, resulting deficits exacerbate the financial challenges. This has been the case over a number of years, but is increasingly common as a result of the national recession that began in December of 2007 (it should be noted that Michigan never recovered from the 2001 recession, and that this state has been in recession for nearly a decade).

The State of Michigan has adopted a number of statutes intended to prevent local government fiscal crises and to help deal with crises when they do occur. Prior to 1988, local government fiscal emergencies were handled on an ad hoc basis. PA 101 of 1988

was adopted in response the imposition of a court-appointed receivership on the City of Ecorse. The Local Government Fiscal Responsibility Act, PA 72 of 1990, replaced PA 101 of 1988. PA 72 of 1990 allowed direct state intervention in the affairs of local units of government, by providing a mechanism for state intervention in local governments that incur a financial emergency. PA 72 also extended the provisions of PA 101 to school districts: those provisions are outside the scope of this report.

A full description of relevant state statutes including PA 72 of 1990, as well as recommendations for improvements in state oversight, are included in the July 2000 report, *Avoiding Local Government Financial Crisis: The Role of State Oversight*, Citizens Research Council Report No. 329, available on the CRC website, www.crcmich.org.

Use of the terms "bankruptcy" and "receivership" may express the level of concern local government officials have, or wish to convey, about the financial condition of their communities, but they are not particularly accurate or appropriate in the context of Michigan local government.

Two factors prompt this return to the issue of local government fiscal distress: the current widespread and pervasive nature of the financial challenges facing Michigan's local governments (including governmental units that have traditionally been well-managed), and the severity of the problems facing the City of Detroit. Local government financial crises can have a serious effect on the quality of life in communities, and on the perception and future economic development of those communities.

Additionally, the increasing frequency of allusions to municipal bankruptcy or receivership indicates that a review of Chapter 9 of the federal Bankruptcy Code, and clarification of the difference between insolvency and bankruptcy, would be useful. (While a number of high profile, Michigan-based auto suppliers continue to struggle in bankruptcy, the success of pre-negotiated bankruptcy for Chrysler and General Motors has increased awareness, and possibly acceptance, of the potential of that approach to shedding liabilities.)

This paper will define some of the terms related to governmental fiscal distress, and will review the Local Government Fiscal Responsibility Act, Chapter 9 of the federal Bankruptcy Code, the special structures created to address New York City's financial emergency in 1975 and Pittsburgh's 2004 fiscal crisis, and other approaches that could be considered as an alternative to PA 72.

Insolvency, Bankruptcy, Receivership, and Emergency Financial Managers

A number of local government officials in fiscally distressed communities have in recent months used the terms "bankruptcy" and "receivership." Use of these words may express the level of concern those officials have, or wish to convey, about the financial condition of their communities, but they are not particularly accurate or appropriate in the context of Michigan local government.

Cash flow **insolvency** is one of several conditions necessary to file for bankruptcy under Chapter 9 of Title 11 of the United States Code, 11 U.S.C. 101 to 1330 (the Bankruptcy Code). This form of insolvency is the inability to meet debts as they fall due. Balance sheet insolvency, which refers to a condition of negative net assets, in which liabilities exceed assets, is not relevant to governments. Generally, governments' operations and debt are paid and secured not by assets but by taxes. The condition of insolvency may be temporary and does not necessarily lead to state intervention.

A government that fails to meet a debt is **in default**. Generally, a default is cured by refinancing or renegotiating the debt, but the creditor may seek a **judgment levy** through court action.

Under Chapter 9, the condition of insolvency is addressed by the automatic stay provision of Section 362, which stops all collection actions against the debtor at the time the bankruptcy petition is filed. Section 922(d) provides that the automatic stay does not apply to debts secured by pledged special revenues, such as revenue bonds. In spite of the fact

that bankruptcy addresses the condition of insolvency, insolvency and bankruptcy are not synonymous.

Municipal **bankruptcy** is a specific process available under Chapter 9 of the federal Bankruptcy Code that allows the reorganization of cities, villages, townships, and counties, but not states. The federal law provides that states must specifically authorize their municipalities to use Chapter 9. No Michigan municipality has ever filed for bankruptcy, but the process is technically available only under the conditions specified in the Local Government Fiscal Responsibility Act, PA 72 of 1990 as amended.

PA 72 provides that if an emergency financial manager is unable to resolve the financial emergency, he or she may request approval from the local emergency financial assistance loan board to authorize the local government to proceed under Chapter 9.

PA 72 provides that if an emergency financial manager is unable to resolve the financial emergency, he or she may request approval from the local emergency financial assistance loan board to authorize the local government to proceed under Chapter 9.

Receivership may be a form of corporate bankruptcy in which the court appoints a receiver to run the company and recoup as much of the unpaid loans as possible, by liquidation if necessary. Receivership may occur when a state or federal regulator places a bank or financial institution under the control of a receiver pursuant to a statute. A court order may place a receiver over property, with or without the consent of the owner, to preserve that property during a lawsuit if there is a danger the property will be removed from the jurisdiction of the court if a receiver is not appointed. A receiver may be appointed over all, or only the contested part, of the property of an individual, partnership, or corporation. The receiver is responsible for administering, conserving, rehabilitating, or liquidating the assets for the benefit of creditors.

Under municipal bankruptcy, no receiver is appointed: the local government develops a plan for adjusting its debts and the court approves or disapproves that plan. The court does appoint a trustee who appoints a creditors committee, but the trustee does not monitor the financial operations of the municipality. The local government itself implements the plan of adjustment under the oversight of the court.

An **emergency financial manager** may be appointed under PA 72 of 1990 if a financial emergency is found to exist in a local government and no consent agreement has been negotiated to resolve the emergency. An emergency financial manager assumes the power and duties of the chief executive officer and legislative body, and may reorganize the government structure and renegotiate contracts.

Judgment Levies

A clear indication of local government fiscal distress is the inability to pay a debt. In that case, the possible remedies available to the creditor include filing a lawsuit against the municipality seeking payment (alternatively, the creditor could choose to write the debt off or offer to renegotiate the debt, or the creditor could ask the state to conduct a review under the Local Government Fiscal Responsibility Act, but the creditor cannot force the municipality into bankruptcy). If the creditor prevails in the lawsuit and receives a favorable judgment, the court can issue an order (a "writ of mandamus") directing the local government to levy and collect taxes in an amount sufficient to pay the judgment. The municipality is thereby directed by the court to impose a judgment levy on taxpayers. This approach transfers the financial obligation to taxpayers and does not require, or even imply, any change in the administration or operation of the local government. This form of relief for the creditor is based on the premise that residents should pay for the debts incurred by their local government.

One of the threshold events in the Local Government Fiscal Responsibility Act is the imposition of a judgment levy without the prior approval of the local government's legislative body.

In Michigan, this approach has been used by members of local government pension systems to force sponsoring local governments to levy taxes to fund those systems.

One of the threshold events in the Local Government Fiscal Responsibility Act is the imposition of a judgment levy without the prior approval of the local government's legislative body.

Fiscal Indicator Scores

The Michigan Department of Treasury has developed fiscal indicator scores for all local general purpose governments in the state. Though not necessarily predictive of a local government's future financial condition, the scores are intended to provide public officials and citizens with objective information about cities, villages, townships, and counties. Each community is scored, with 0-4 points representing a fiscally neutral position requiring no state action; 5-7 points designating a "fiscal watch" condition; and 8-10 points denoting fiscal stress. Local governments that score 8-10 are notified, placed on a watch list for the current year and following year, and receive consideration for state review. The most recent scores published are for 2008 and are available on the Michigan Department of Treasury website (www.michigan,gov/treasury).

Local Governments with 2008 Cumulative Scores 8-10

Cities*

Crystal Falls, Iron County (8)
Jackson, Jackson County (8)
Standish, Arenac County (8)
Benton Harbor, Berrien County (9)
Ecorse, Wayne County (9)
Muskegon Heights, Muskegon County (9)
Wakefield, Gogebic County (9)

Villages

Elberta, Benzie County (8)
Middleville, Barry County (8)
Owendale, Huron County (8)

Townships

McMillan, Ontonagon County (8)
Royal Oak, Oakland County (8)
Bedford, Calhoun County (9)
Genesee, Genesee County (9)

Counties

Hillsdale (8)

*The state's largest city, Detroit, was not included in the 272 cities scored.

The applicable statutory approach to communities in a financial emergency is the Local Government Fiscal Responsibility Act, PA 72 of 1990. However, the Bureau of Local Government Services of the Michigan Department of Treasury has created the Treasury Rapid Response Team (TRRT) for Fiscally Distressed Local Units to provide a quick and efficient methodology for Treasury to access fiscally distressed local units of government and to give them fiscal repair options that may help avoid the PA 72 process. The Treasury website lists the methodology and benefits of TRRT:

a. Utilize various organizations such as the Michigan Municipal League (MML), Michigan Townships Association (MTA), and the Michigan Association of Counties (MAC), if necessary, to facilitate meetings with the local governmental officials and a TRRT member.

b. The organization/local unit will get credit for addressing the financial issues early and timely.

c. At the meeting the TRRT members will ask the local officials what they feel comfortable sharing with the team about their fiscal distress.

d. Once the fiscal issues are disclosed the TRRT will give the local government officials a list of fiscal health building options that do not include P.A. 72 triggers.

e. If it is determined that P.A. 72 must be invoked the local government officials will be given the 4 page summary of P.A. 72 that will guide them through what to expect from that process.

f. If it is determined after the meeting that P.A. 72 needs to be invoked the formal process can begin without unnecessary delay.

Using the TRRT will wisely use Treasury resources in identifying which local units of government require assistance without P.A. 72 or with P.A. 72 while giving substantial credit for the assistance to the organizations that represent various local units of government, or to the local unit of government that asks for our help on its own, according to Treasury.

The Local Government Fiscal Responsibility Act

History

The State of Michigan has adopted a number of statutes designed to prevent local governments from falling into a financial crisis. These include the Uniform Budgeting and Accounting Act, PA 2 of 1968; the Emergency Municipal Loan Act, PA 243 of 1980; the Fiscal Stabilization Act, PA 80 of 1981; the Revised Municipal Finance Act, PA 34 of 2001; and the Home Rule Cities Act, PA 279 of 1909. The state constitution provides for the removal or suspension of local officials. In spite of these statutory and constitutional provisions, the current fiscal condition of a number of Michigan local governments is challenged.

An extensive description of the Local Government Fiscal Responsibility Act was published by CRC in August, 1990 at the request of the Michigan Commission on Intergovernmental Relations. That report, *An Analysis of the Effectiveness of the Local Government Fiscal Responsibility Act*, which is available on the CRC website, describes the law as it was at that time. PA 72 of 1990 was subsequently amended by PA 265 of 1992, PA 408 of 2002, PA 282 of 2003, and PA 181 of 2009. A summary of the statute is contained in this section, and a complete description of the PA 72 process is contained in **Appendix A**, of this report.

Six general purpose Michigan communities have had emergency financial managers appointed under PA 72 of 1990:

- City of Hamtramck, 2000
- City of Highland Park, 2001
- City of Flint, 2002
- Village of Three Oaks, 2008
- City of Ecorse, 2009
- City of Pontiac, 2009

On February 26, 2010, the governor declared a financial emergency in Benton Harbor. (Although school districts are outside the scope of this report, it should be noted that an emergency financial manager has also been appointed for the Detroit Public School District.)

According to PA 72 of 1990, there are three possible strategies that can be employed for a local government that is in a declared fiscal emergency:

- Locally elected officials can develop and implement a plan to resolve the crisis under a consent agreement negotiated with the state-appointed review team.
- A state-appointed emergency financial manager can develop and implement a plan to resolve the financial crisis.
- If the emergency financial manager recommends and the state approves, the local government can file under Chapter 9 of the federal Bankruptcy Code.

The PA 72 process starts with a preliminary review by the state treasurer to determine if a financial problem exists. The state treasurer must inform the governor within 30 days after beginning the preliminary review whether or not the investigation has determined that a serious financial problem may exist because one or more conditions indicative of a serious financial problem exist within the local government. If the state treasurer's preliminary review determines that a serious financial problem may exist, or if the governing body of a local government, by resolution, requests assistance in meeting the ordinary needs of government and identifies the existing financial conditions that make the request for assistance necessary, the governor must appoint a review team composed of the state treasurer, auditor general, a nominee of the senate majority leader, a nominee of the speaker of the house, and other state officials or other people with relevant professional experience within the local government.

The review team must report to the governor within 60 days of their appointment (a 30-day extension may be granted) whether a serious financial problem exists. The review team's report must include one of three possible conclusions:

- A serious financial problem does not exist in the local government.
- A serious financial problem exists in the local government, but a consent agreement contain-

ing a plan to resolve the problem has been adopted pursuant to section 14(1)(c).

- A local government financial emergency exists because no satisfactory plan exists to resolve a serious financial problem.

If the governor determines that a financial emergency exists, he or she then assigns the responsibility for managing the local government financial emergency to the local emergency financial assistance loan board, which appoints an emergency financial manager (EFM). The EFM is chosen solely on the basis of competence and cannot have been either an elected or appointed official or employee of the local government for at least five years before the appointment. The EFM may hire staff and contract for professional assistance, after obtaining approval of the local emergency financial assistance loan board. Those costs are born by the local government.

> The Act 72 process is the only way a local government in Michigan can be authorized to file under Chapter 9 of the federal bankruptcy code.

In consultation with the local government, the EFM is responsible for developing and implementing a financial plan that balances expenditures with the EFM's revenue estimate and that pays debt service and other legal obligations when due. Both the plan and revenue estimates may be reviewed and revised as necessary by the EFM, and while the written plan is to be made public, it does not require public approval. The EFM is authorized by the statute to order officials or employees of the local government to take those actions necessary to implement the financial plan. An emergency financial manager may assume the power and duties of the chief administrative officer and legislative body, and may renegotiate contracts, but may not abrogate contracts.

If the EFM successfully resolves the fiscal problem, he or she informs the local emergency financial assistance loan board that the financial emergency has been solved. The governor may determine that the conditions for revoking the declaration of a financial emergency have been met after receiving a recommendation from the local emergency financial assistance loan board.

If however, the EFM is unable to resolve the financial emergency, he or she may request approval from the local emergency financial assistance loan board to authorize the local government to proceed under Chapter 9 of Title 11 of the United States Code, 11 U.S.C. 101 to 1330. That notice to the local emergency financial assistance loan board must include a determination by the EFM that no feasible financial plan can be adopted that can satisfactorily resolve the financial emergency in a timely manner, or a determination by the emergency financial manager that an adopted financial plan, in effect for at least 180 days, cannot be implemented, as written or as it might be amended, in a manner that can satisfactorily resolve the financial emergency in a timely manner. The local emergency financial assistance loan board has 60 days to approve or disapprove the request. This is the only way a local government in Michigan can be authorized to file under Chapter 9 of the federal bankruptcy code.

Effectiveness

Of the seven general purpose local government financial emergencies that have been declared, Hamtramck and Flint have emerged from the Act 72 process, Ecorse and Pontiac currently have an emergency financial manager, Highland Park and Three Oaks no longer have an emergency financial manager in place, but the declaration of a financial emergency still exists. On April 1, 2010, an emergency financial manager was appointed for the City of Benton Harbor.

A review of quarterly reports filed by emergency financial managers reveals a variety of problem areas that these state appointees have faced:

- Accounting, budgeting, financial records, late payments, and cash management
- General management, need for operational efficiencies
- Staffing, overtime, cost and administration of employee benefits, union contracts

- Insurance costs, costs of contracts for service provided to the local government
- Lawsuits and legal fees
- Condition of infrastructure, illegal dumping, code enforcement, abandoned property, development pressures
- Service levels, pricing of services provided by the local government
- Sale of surplus property

PA 72 places the burden of resolving a local government fiscal emergency on the state. State-appointed emergency financial managers have generally been successful in cutting expenses and balancing budgets over time, but it is unclear if this process would work if applied to a city the size of Detroit.

Municipal Bankruptcy: Chapter 9, Title 11, of the United States Code

Congress passed municipal bankruptcy legislation in 1934, during the Great Depression, when many municipalities that were unable to meet their obligations sought protection. The U.S. Supreme Court in 1936 found that the 1934 act was an improper interference with the sovereignty of states. In 1937, Congress enacted a revised act that was upheld by the Supreme Court and that has been amended several times.

Recent History

Historically, filing for bankruptcy has been a last resort for municipalities, and no Michigan municipality has ever filed for protection under Chapter 9. The traditional argument against the use of bankruptcy is that it would negatively affect the municipality's credit rating, reduce access to credit, and increase future costs of borrowing. A municipal bankruptcy is believed to have a detrimental impact on the state's credit rating and on that of other local governments in the state. The moral argument against use of bankruptcy relates to making only promises (i.e. contracts) that can be kept, and honoring promises that have been made. The practical argument is that bankruptcy is expensive, contentious, and can take several years.

Chapter 9 allows municipalities to restructure and reorganize assets and debts, and to abrogate contracts, but the court is much less active in municipal bankruptcies: no receiver is appointed and the court is generally limited to approving the petition, confirming a plan of adjustment developed by the municipality (not by the creditors), and ensuring implementation of the plan.

The restructuring of the domestic automobile industry, which has shaped the economy of this state, has in large part been accomplished through corporate bankruptcy. Multiple large and small auto suppliers have used federal bankruptcy to restructure (and in some cases to liquidate). The apparent success of the structured bankruptcies of Chrysler and GM, as well as the well publicized municipal bankruptcies of Orange County in 1994 and the City of Vallejo in 2008 (both are in California, which provided a blanket authorization for local agencies to utilize federal bankruptcy in 1949), have increased interest in the potential of this option to give governmental filers a fresh start.

Municipal bankruptcy differs from corporate bankruptcy in important ways. Private companies can be liquidated and cease to exist, but municipalities continue to have critically important responsibilities to residents. Chapter 9 allows municipalities to restructure and reorganize assets and debts, and to abrogate contracts, but the court is much less active in municipal bankruptcies: no receiver is appointed and the court is generally limited to approving the petition, confirming a plan of adjustment developed by the municipality (not by the creditors), and ensuring implementation of the plan. The municipality is not required to liquidate assets to pay creditors, and the court may not increase tax rates in the municipality. Because the court has "cram down" authority, not all creditors have to approve the plan of adjustment, which is developed by the municipality. (A "cram down" is the imposition of a reorganization plan by a court over the objection of some classes of creditors.)

While the traditional use of Chapter 9 has been to reorganize debt through extending maturities, reducing the amount of principal or interest, or refinancing using a new loan, the Vallejo, California case demonstrated that municipal bankruptcy can be used to void union contracts.

Vallejo officials blamed the city's financial problems on police and firefighter salaries and benefits, which made up about 80 percent of the general fund budget; unexpected retirements resulting in unbudgeted payouts; and the housing market crash and struggling economy. The Vallejo City Council voted to file for Chapter 9 in 2008. In the city's Motion for Approval of the Rejection of Collective Bargaining Agreements, the city noted the value of future health ben-

efits already earned (which the Governmental Accounting Standards Board now requires to be reported annually) as well as negotiated salary increases and unfunded pension obligations. Under Chapter 9, contracts can be rejected if they are so burdensome that they would result in the inability of the debtor to adjust its debt absent rejection. The police and white collar unions made supplemental agreements with the city and the motions against them were voluntarily dismissed. Vallejo was allowed to abrogate the firefighter contracts.

Municipal bankruptcy has not been used to abrogate pension obligations that are protected in state constitutions. Only 19 states have specific authorization procedures in place for municipal bankruptcy, and only nine states have constitutional provisions that participants in a public retirement system have a guaranteed right to a benefit that has been promised. Michigan and Pennsylvania have both provisions for municipal bankruptcy and constitutional guarantees for public pensions. According to the Allegheny Institute for Public Policy "Municipal bankruptcy may be a vehicle through which municipalities begin to deal with pension obligations and other legacy costs that have become too burdensome. The Pennsylvania Constitution prohibits the revocation of pension benefits through laws or ordinances, but this likely would not apply to proceedings before a bankruptcy judge. A recent high profile case in Vallejo, CA dealt with the issue of whether collective bargaining agreements and constitutional provisions on contracts would hold up in a bankruptcy proceeding. The court held that they would not, noting that when a state permits municipal filings it is valuing the benefits of bankruptcy for its municipalities greater than its state laws."[1]

Only 19 states have specific authorization procedures in place for municipal bankruptcy, and only nine states have constitutional provisions that participants in a public retirement system have a guaranteed right to a benefit that has been promised. Michigan and Pennsylvania have both provisions for municipal bankruptcy and constitutional guarantees for public pensions.

[1] Allegheny Institute for Public Policy, Issue Summary: Municipal Bankruptcy, Updated January 2010.

Other recent municipal bankruptcies, and their primary causes, include the following:

- Orange County, California, 1994, investment losses
- Prichard, Alabama, 1999, inability to pay pensions
- Desert Hot Springs, California, 2001, loss of a housing discrimination lawsuit
- Millport, Alabama, 2005, loss of sales tax revenue after a factory closing
- Moffett, Oklahoma, 2007, loss of ability to issue traffic tickets
- Gould, Arkansas, 2008, spent money withheld to pay employee income taxes
- Westfall Township, Pennsylvania, 2009, loss of a lawsuit
- Washington Park, Illinois, 2009, loss of lawsuits, embezzlement by employees
- Prichard, Alabama, 2009, inability to pay pensions

Not all units of government may file for protection under the federal bankruptcy code. In order to be eligible, all of the following conditions must be met:

1. The entity must be a municipality, which is defined as a political subdivision or public agency or instrumentality of the state. This includes counties, cities, villages, townships, school districts, public improvement districts, and some special districts. (This is the definition of municipality used in this report.) States cannot file for bankruptcy.
2. The municipality must have specific authorization from the state to be a debtor. Nineteen states have specific authorization procedures in place for municipal bankruptcy. In Michigan, this can only be achieved through the process contained in PA 72 of 1990, described above.

3. The municipality must be insolvent on a cash flow basis. This condition is met when the municipality is not paying its debts when they become due or is unable to pay debts as they become due.
4. The municipality must desire to adjust its debts. It must file a voluntary petition and cannot be forced into bankruptcy by its creditors.
5. The municipality must demonstrate one of the following:
   a. Obtained approval of creditors holding a majority of the dollar value of claims in each class that the debtor intends to impair; or
   b. Negotiated in good faith with creditors and failed to obtain the agreement of creditors holding a majority of the dollar value of claims in each class that the debtor intends to impair; or
   c. Be unable to negotiate with creditors because such negotiations are impracticable; or
   d. Reasonably believe that a creditor may attempt to obtain a preferential transfer (a payment larger than would be likely under bankruptcy).

Chapter 9 places the burden of resolving a local government financial crisis on creditors and employees. A complete description of the municipal bankruptcy process is contained in **Appendix B**.

Other Experiences

Michigan is not the only state struggling with managing fiscal crises at the local government level. In one of the most well-known crises, both the State of New York and the federal government resisted appeals for assistance from New York City. In contrast, Pennsylvania layered one oversight board over another to address Pittsburgh's financial emergency.

The New York City Crisis

A number of factors, including a declining manufacturing base, very generous welfare programs, and poor accounting and budgeting practices, contributed to a financial emergency in New York City. By 1974, New York City had become reliant on frequently maturing, short-term revenue anticipation notes (RANs) to cover operating expenses; this debt was increasingly difficult to retire. Creditors had formed the Financial Community Liaison Group to try to pressure the city into changing its fiscal policies (decreasing labor costs, raising taxes, cutting welfare expenditures). When this failed, the city's credit rating was reduced and creditors increased interest rates, and then, in early 1975, banks refused to extend any more credit.

If the City of Detroit has a financial emergency, it may be that solving Detroit's fiscal difficulties, like New York City's, requires a specially tailored strategy that accommodates its size, complexity, and political realities.

In response, the State of New York in June, 1975, created the Municipal Assistance Corporation (MAC), which was initially authorized to issue $3 billion in bonds backed by the city's sales tax, stock and transfer tax, and state aid. MAC, composed primarily of banking and business leaders, also demanded that the city impose fiscal austerity and responsible accounting and budgeting. (MAC eventually sold almost $10 billion in bonds, serviced them all, and voted itself out of existence in 2008.)

In September, 1975, the state created the Emergency Financial Control Board (EFCB) composed of the mayor, governor, city and state comptrollers, and three private-sector business people. The EFCB controlled city revenues and had oversight of the city budget. (New York City still submits its budget to the renamed Financial Control Board.)

But on October 17, 1975, the city's lawyers were in New York State Supreme Court to file a bankruptcy petition, and a statement was prepared announcing that the city had insufficient cash on hand to meet debt obligations. At that point, union leaders agreed to use union pension funds to purchase $2.5 billion in city securities, and to refinance $700 million in MAC bonds and $450 million in city notes, thereby allowing the city to avoid the Chapter 9 filing.

The state legislature passed a 25 percent increase in the city's income tax as well as higher levies on businesses and inheritances. The city began a process of laying off employees, reducing various payments, and closing facilities, and reforming its financial practices.

During the crisis, the city appealed to the federal government for a bailout, which was rejected, prompting the famous *Daily News* headline: "Ford to City: Drop Dead." (President Ford did not actually say those words.) Eventually, in December, the federal government agreed to provide $2.3 billion each year through 1978 to meet short-term debt obligations. These federal loans had to be repaid within the year they were made, and carried an interest rate of one percent higher than the U.S. Treasury rate (then about seven percent).

If the City of Detroit has a financial emergency, it may be that solving Detroit's fiscal difficulties, like New York City's, requires a specially tailored strategy that accommodates its size, complexity, and political realities. The establishment of an Emergency Financial Control Board, similar to that created by the State of New York to oversee New York City's financial affairs, may be more appropriate for a city the size and complexity of Detroit. That board could include both city and state officials as well as private sector experts, and could oversee the budget of the City of Detroit and direct implementation

of deficit elimination plans. In order to be effective, the board would have to have authority to reject city budgets that contain unrealistic revenues, and to force the city to eliminate deficits as they arise. And in order for the board to be sufficiently well informed to make appropriate decisions, the city's accounting system would have to be improved to the point that financial information is timely and accurate. Questions relating to this approach include whether an oversight board would have to have a role in union negotiations in order to be effective, and how arbitration required under PA 312 could be used by public safety employees to reduce the potential effectiveness of an oversight board.

Pennsylvania's Approach

Pennsylvania's Municipalities Financial Recovery Act, Act 47 of 1987, allows additional taxing authority (specifically, a nonresident wage tax) to municipalities that are declared fiscally distressed, based on the theory that fiscal distress is at least partially due to inelastic revenues that do not keep pace with inflation and the increased costs of municipal services. The statute requires that an Act 47 coordinator be appointed by the state Community and Economic Development Department and paid by the state. The act includes the following provisions:

- Criteria for identifying distress.
- Powers and duties of the Department of Community and Economic Development in assisting communities.
- Procedure for declaring a municipality as being distressed and for appointing a distressed municipality coordinator.
- Requirement for development of a fiscal plan, unique to the municipality, that will enable the municipality to remedy its distress.
- Provision that the municipality has the option of formulating its own fiscal plan.
- Requirement that the state withhold all state funds except those considered absolutely essential when a distressed municipality refuses to adopt a fiscal solvency plan.
- If the Act 47 coordinator recommends filing, or if other specified conditions are met, authorization for a distressed municipality to file a municipal debt readjustment action under federal law.[2]

Contracts negotiated prior to a municipality falling under Act 47 remain in effect until they expire; new contracts cannot violate the terms of the recovery plan. Act 47 is neither a state takeover nor a state bailout: the Act 47 coordinator drafts a recovery plan in consultation with city officials, employees, community groups, and residents, and that plan is approved by the mayor and city council, or the municipality has the option of formulating its own fiscal plan. The coordinator oversees implementation of the plan, but elected officials continue to run the city.

Pennsylvania has adopted an additional act to address the problems in a particular city. The Intergovernmental Cooperation Authority Act for Cities of the Second Class, Act 11 of 2004, applies only to Pittsburgh, permits the creation of a financial oversight authority, and is intended to work concurrently and equally with Act 47.

Four of the ten largest cities in Pennsylvania are in some type of financial oversight, either Act 47, an oversight board, or both. A total of 18 cities are currently under Act 47; six others have emerged.

Four of the ten largest cities In Pennsylvania are in some type of financial oversight, either Act 47 (Scranton and Reading), an oversight board (Philadelphia, which is not subject to Act 47), or both (Pittsburgh). A total of 18 cities are currently under Act 47; six others have emerged.

Pittsburgh

In 2003, the City of Pittsburgh laid off 446 employees, closed some facilities and discontinued some services; its bond rating was downgraded to below investment grade. The city's dysfunctional and decentralized accounting and payroll systems provided no way to ascertain the true costs of labor or fringes

[2] Pennsylvania General Assembly, Local Government Commission; Pennsylvania Legislator's Municipal Deskbook, Third Edition, 2006, pgs 185-186.

associated with the various departments.

The mayor sought protection under Act 47 and asked that the city be placed in "distressed" status. After a review of the city's finances, the state approved the request, which triggered the requirement that the city develop a recovery plan. Consultants[3] were appointed by the secretary of the state's Department of Community and Economic Development to act as the Act 47 recovery plan coordinator to develop the recovery plan, which was approved by the mayor and city council in June, 2004. That 234-page document included more than 200 specific recommendations, including provisions for operating changes, intergovernmental cooperation, managed competition, workforce cost containment, improved financial management, and tax policy. In November, 2004, the governor and legislature exercised their right to modify some elements of the recovery plan.

Since 2004, there have been three groups planning the financial future of Pittsburgh: the Act 47 recovery plan coordinator team; the Intergovernmental Cooperation Authority; and the city's elected mayor and city council.

In 2007, the city's request that it be removed from Act 47 was denied and in 2008, the coordinator was directed to develop a new recovery plan. Pittsburgh's second five-year recovery plan, which was approved June 30, 2009, is intended to focus on legacy costs and to provide a roadmap for exiting Act 47 oversight. The recovery plan coordinator continues to oversee implementation of the plan.

In direct response to Pittsburgh's financial crisis, the state also created the Intergovernmental Cooperation Authority (ICA), a financial oversight body adopted in early 2004 (Act 11 of 2004) by the Pennsylvania legislature, specifically for Pittsburgh. The ICA board is appointed by the governor and legislature and is funded by state appropriations; the city is contractually obligated to fund any portion of the ICA's budget that exceeds the state appropriation. The ICA controls city revenues, approves or disapproves the annual and capital budgets and corresponding five-year financial plans prepared by the city administration, and makes recommendations to the state General Assembly. The ICA uses its control of revenues and budget approval process to force process, technology, and operational improvements, with an emphasis on cost control. The city is required to make quarterly financial reports no later than 45 days after the close of the quarter, and to insure that contracts, including collective bargaining agreements, are compliant with the approved financial plan.

The goal of the ICA is to bring about changes in the cost structure of "second class cities," including balancing the budget and addressing legacy costs: "to provide for the health, safety and welfare of their citizens, pay principal and interest owed on their debt obligations when due, meet financial obligations to their employees, vendor and suppliers, and provide for proper financial planning procedures and budgeting practices, as mandated by Act 11 of 2004." The ICA has commissioned a number of reports by outside experts on various aspects of city operations and systems, including a strategic plan for public safety, and convened numerous meeting of public safety unions, supervisors, and the city administration. The state-appointed, volunteer board of the ICA works with the members of the Municipalities Financial Recovery Act team (the Act 47 team) and the city government through an intergovernmental cooperation agreement.

Since 2004, there have been three groups planning the financial future of Pittsburgh: the Act 47 recovery plan coordinator team; the Intergovernmental Cooperation Authority; and the city's elected mayor and city council. (Adding to the complexity and expense, the city used internal staff and also engaged an outside consultant to confirm findings of the Act 47 team and the ICA.) While published statements stress the cooperation among the three groups, and while Act 47 was the only option available in 2003 when the city experienced a crisis, it may be that one state-appointed oversight group with both planning and budgetary responsibility would have been more efficient.

[3] Public Financial Management and Eckert Seamons Cherin & Mellott, LLC.

Other Approaches

State or Federal Bailout

The easiest resolution to a local government fiscal crisis, from the perspective of the local government, would be a state or federal bailout. While this solution could be appropriate in unusual and discrete situations where local officials were not at fault, the State of Michigan is facing its own financial crisis and the federal government has thus far shown no inclination to provide general relief (although extraordinary aid has been provided for states and local governments for specific purposes as part of the American Recovery and Reinvestment Act (ARRA)).

Furthermore, a bailout could encourage and reward irresponsible behavior, especially when (as in Detroit, Ecorse, and some other communities) local officials have been convicted of corruption, have adopted budgets that were balanced with unrealistic revenues, have repeatedly failed to make expenditure reductions necessary to balance budgets, and have failed to address problems that are long standing and structural (not situational or cyclical).

A bailout could encourage and reward irresponsible behavior, especially when local officials have been convicted of corruption, have adopted budgets that were balanced with unrealistic revenues, have repeatedly failed to make expenditure reductions necessary to balance budgets, and have failed to address problems that are long standing and structural.

Amend PA 72 of 1990

PA 72 of 1990 has worked reasonably well in those situations where it has been used. It is obvious from past experience, however, that the selection of the individual who is to serve as emergency financial manager is key. It may be that in certain cases (in cities of over 500,000 population, for example) the complex financial and political situation demands a slightly different approach, and that current or elected officials or appointees may be the best to serve as EFM. If the legislative body were an impediment to implementing financial reforms, appointing a chief executive officer to be EFM would allow that person to relieve the legislative body of authority and implement necessary budgetary and operational changes without their approval. If a financial expert who was recently employed by the city were judged best able to resolve the crisis, an amendment to the act could allow for his or her appointment. This approach would eliminate the system of checks and balances that is inherent in the mayor-council form of government. If it were to be considered, it should be in conjunction with a state oversight board.

The political appeal of this approach is that the state would not be placing an "outsider" with no connection to the community in a position of authority. The problem with the approach is that it does not remove local political considerations from the process.

There is no prohibition in any Michigan statute on the voluntary renegotiation of local government contracts. There is, however, no way to amend any Michigan statute to allow abrogation of local government contracts. Therefore, if the critical problem facing a local government is the inability to afford contractually obligated pay and benefits, unions refuse to make concessions, and no further layoffs may reasonably be made without endangering public health and welfare, no remedy for that problem is possible outside of bankruptcy. Similarly, if the critical problem facing a local government is the inability to make payments on limited tax general obligation debt, and bond or note holders refuse to make concessions, no remedy for that problem is possible outside of bankruptcy.

State Takeover

Rather than appoint an emergency financial manager or an oversight board for a local government with a financial emergency, the state could designate a state agency that actually exercises financial and operational control of local governments that have financial emergencies. This agency could be

authorized to sell notes and bonds guaranteed by defined revenues (including, but not limited to, deficit funding bonds and, with court cooperation, judgment bonds), to raise extraordinary revenues in a designated local unit of government, or to channel special state resources to the unit. The state agency could be empowered, where feasible, to execute contracts transferring all service provision responsibilities for a city, village, or township to the county or other appropriate unit of government. Although there are constitutional considerations, the state agency could propose and advocate for a merger of local units of government, or propose and advocate for replacing a dysfunctional charter with a model charter.

The proposed agency could be designed to be very intrusive, approving budgets and expenditures, hiring and firing local department heads and employees, negotiating and approving contracts, and managing operations. Or, it could be less intrusive, negotiating a rehabilitation plan and overseeing its implementation by local officials. There could be an established set of threshold events that trigger the state involvement (if, for example, the community's credit rating falls below investment grade or if the local government is unable to meet its operating expenses), or the governor or legislature could be authorized to designate specific local governments for takeover.

A standing local government administrative agency would encounter the same problems that an emergency financial manager faces, but might be able to develop extraordinary in-house capacity based on experience over time in a number of communities.

A standing local government administrative agency would encounter the same problems that an emergency financial manager faces, but might be able to develop extraordinary in-house capacity based on experience over time in a number of communities.

Placing the Burden of Local Fiscal Distress

An academic approach to categorizing the various strategies for resolving local government fiscal crises is to identify where the burden of resolving the crisis is placed: on the taxpayers through judgment levies; on the state because it is responsible for local governments; or on creditors and employees through bankruptcy.[4] In fact, a combination of stakeholders assumes the burden.

As a practical matter, even without judgment levies, residents of fiscally distressed local governments will assume at least part of the burden of resolving the financial problem. This is because service reductions, facility closures, and delayed maintenance of infrastructure will very likely be part of the strategy to reduce expenditures. It can be argued that placing the burden on residents promotes efficient resource allocation, because residents can determine fiscal policies through the political process. While the present confluence of events-declining property values, high and long-term unemployment, industrial restructuring- contributing to current problems could not be prevented, or even predicted, by local officials, a number of Michigan communities have long resisted addressing serious structural problems. Furthermore, placing the burden on residents, either by raising taxes or reducing services, encourages those resident individuals and business that are more mobile to move, further reducing the tax base.

As a practical matter, even without judgment levies, residents of fiscally distressed local governments will assume at least part of the burden of resolving the financial problem.

The burden will be shared by local government employees, who will lose jobs, have pay rates frozen or reduced, and benefits adjusted downward. Public employee labor contracts may be voluntarily renegotiated at any time, but may be abrogated only under Chapter 9.

Local officials will assume part of the burden, either because they are forced to make unpopular decisions or because they are relieved of financial responsibility by an emergency financial manager or oversight agency. While local officials may not be able to affect the underlying causes of a fiscal emergency, theirs is the primary responsibility for developing and implementing a plan that balances realistic revenues with essential services.

The State of Michigan is not now in a position to bail out local governments, and indeed has been contributing to their distress by reducing revenue sharing payments and imposing unfunded mandates. The state has accepted part of the responsibility by establishing a process for identifying financial emergencies and placing an emergency financial manager in charge of distressed communities.

Creditors and vendors cannot force local governments to reduce deficits or adopt responsible financial plans, though financial institutions can set conditions for making loans to the municipality. Creditors cannot force a municipality into bankruptcy, but outside of bankruptcy, creditors have the right to sue local governments for payment. Under bankruptcy, creditors (and employees) can be forced to shoulder the burden of a local government financial emergency.

[4] Omer Kimhi, Boston University Law Review, Reviving Cities: Legal Remedies to Municipal Financial Crises.

Summary and Conclusions

In Michigan, local governments of all kinds are facing financial challenges. In general, these challenges are defined by declining property tax revenues attributable to the real estate collapse and to economic restructuring. In many well managed communities, the decline in revenues has provided an unexpected, and unprecedented, challenge. In other communities with long standing problems, the political environment has not allowed leaders to make necessary reforms.

The state has developed a strategy for addressing local government financial emergencies, contained in the Local Government Fiscal Responsibility Act, PA 72 of 1990, but that statute has not been used in every instance of local government distress. In particular, the state's largest city, Detroit, may require a different approach if it is deemed to have a financial emergency.

It was only after a court-ordered receivership was established for the City of Ecorse that the Michigan Legislature adopted PA 101 of 1988, the precursor to PA72 of 1990. It may be that a similar event is necessary to motivate a legislative response to Detroit's continuing challenges. Examination of possible alternative strategies, including bankruptcy, is appropriate.

While creditors may sue a local government for payment of a particular debt, this does not constitute a strategy for dealing with that government's fiscal distress. An emergency financial manager appointed by the state in accordance with PA 72 may well be able to improve budgeting, renegotiate contracts, and reduce expenditures. Other possibilities include amending PA 72 to allow a mayor or other current or recently elected or appointed official to be appointed EFM; establishing a financial oversight board with state, local, and private sector representation; or establishing an agency in state government to assume operation and control of a local government that is having a financial emergency. However, if the resolution of the emergency requires abrogation of contracts, only bankruptcy will provide the necessary authority.

If the resolution of a financial emergency requires abrogation of contracts, only bankruptcy will provide the necessary authority.

While a simple bailout is greatly desired by many local officials, the state is unable or at least unwilling, and the federal government so far unwilling, to provide this kind of aid. Nor would a bailout address the underlying cause of local government financial distress in Michigan. At this time in our state, a challenge even greater than balancing local budgets with declining revenues and increasing spending pressures, is rebuilding an economic base devastated by the loss of manufacturing and the collapse of real estate values. The most stringent of cost cutting cannot address this fundamental problem.

Appendix A
The Local Government Fiscal Responsibility Act

Preliminary Review

The statute contains a lengthy process for determining if there is a fiscal emergency in a local government. That process starts with a preliminary review by the state treasurer to determine if a financial problem exists. The preliminary review is triggered by one or more of the events listed in Sec. 12 (MCL 141.1212):

(1) The state treasurer shall conduct a preliminary review to determine the existence of a local government financial problem if 1 or more of the following occur:

(a) The governing body or the chief administrative officer of a local government requests a preliminary review under this article. The request shall be in writing and shall identify the existing financial conditions that make the request necessary.

(b) The state treasurer receives a written request from a creditor with an undisputed claim that remains unpaid 6 months after its due date against the local government that exceeds the greater of $10,000.00 or 1% of the annual general fund budget of the local government, provided that the creditor notifies the local government in writing at least 30 days before his or her request to the state treasurer of his or her intention to invoke this provision.

(c) The state treasurer receives a petition containing specific allegations of local government financial distress signed by a number of registered electors residing within the jurisdiction of the local government equal to not less than ten percent of the total vote cast for all candidates for governor within the jurisdiction of the local government at the last preceding election at which a governor was elected. Petitions shall not be filed under this subdivision within 60 days before any election of the local government.

(d) The state treasurer receives written notification from the trustee, actuary, or at least ten percent of the beneficiaries of a local government pension fund alleging that a local government has not timely deposited its minimum obligation payment to the local government pension fund as required by law.

(e) The state treasurer receives written notification that employees of the local government have not been paid and it has been at least 7 days after the scheduled date of payment.

(f) The state treasurer receives written notification from a trustee, paying agent, or bondholder of a default in a bond payment or a violation of 1 or more bond covenants.

(g) The state treasurer receives a resolution from either the senate or the house of representatives requesting a preliminary review under this section.

(h) The local government has violated the conditions of an order issued pursuant to, or of a requirement of, former 1943 PA 202, the revenue bond act of 1933, 1933 PA 94, MCL 141.101 to 141.140, the revised municipal finance act, 2001 PA 34, MCL 141.2101 to 141.2821, or any other law governing the issuance of bonds or notes.

(i) The local government has violated the conditions of an order issued in the effectuation of the purposes of the emergency municipal loan act, 1980 PA 243, MCL 141.931 to 141.942, by the local emergency financial assistance loan board created by the emergency municipal loan act, 1980 PA 243, MCL 141.931 to 141.942.

(j) The local government has violated the requirements of sections 17 to 20 of the uniform budgeting and accounting act, 1968 PA 2, MCL 141.437 to 141.440, and the state treasurer has forwarded a report of this violation to the attorney general.

(k) The local government has failed to comply with the requirements of section 21 of the Glenn Steil state revenue sharing act of 1971, 1971 PA 140, MCL 141.921, for filing or instituting a deficit recovery plan.

(l) The local government fails to provide an annual financial report or audit that conforms with the minimum procedures and standards of the state treasurer and is required under the uniform budgeting and accounting act, 1968 PA 2, MCL 141.421 to 141.440a, or 1919 PA 71, MCL 21.41 to 21.55.

(m) The local government is delinquent in the distribution of tax revenues, as required by law, that it has collected for another taxing jurisdiction, and that taxing jurisdiction requests a preliminary review.

(n) A court has ordered an additional tax levy without the prior approval of the governing body of the local government.

Finding of a Serious Financial Problem

The state treasurer must inform the governor within 30 days after beginning the preliminary review whether or not his or her investigation has determined that a serious financial problem may exist because one or more conditions indicative of a serious financial problem exist within the local government. The conditions indicative of a serious financial problem are as follows (MCL 141.1214 (2)):

(a) A default in the payment of principal or interest upon bonded obligations or notes for which no funds or insufficient funds are on hand and segregated in a special trust fund.

(b) Failure for a period of 30 days or more beyond the due date to transfer 1 or more of the following to the appropriate agency:

(i) Taxes withheld on the income of employees.

(ii) Taxes collected by the government as agent for another governmental unit, school district, or other entity or taxing authority.

(iii) Any contribution required by a pension, retirement, or benefit plan.

(c) Failure for a period of 30 days or more to pay wages and salaries or other compensation owed to employees or retirees.

(d) The total amount of accounts payable for the current fiscal year, as determined by the state treasurer's uniform chart of accounts, is in excess of ten percent of the total expenditures of the local government in that fiscal year.

(e) Failure to eliminate an existing deficit in any fund of the local government within the 2-year period preceding the end of the local government's fiscal year during which the review team report is received.

(f) Projection of a deficit in the general fund of the local government for the current fiscal year in excess of ten percent of the budgeted revenues for the general fund.

The governor must appoint a review team composed of the state treasurer, auditor general, a nominee of the senate majority leader, a nominee of the speaker of the house, and other state officials or other people with relevant professional experience if the state treasurer's preliminary review determines that a serious financial problem may exist within the local government or if the governing body of a local government, by resolution, requests assistance in meeting the ordinary needs of government and identifies the existing financial conditions that make the request for assistance necessary.

The review team may use the resources of other state agencies and has the authority to review the books and records of the local government. It also has the authority to negotiate a consent agreement with the chief administrative officer of the local government; that agreement must be approved by the governing body of the local government. The agreement may provide for necessary remedial measures and a long-range financial recovery plan requiring specific local actions. The agreement may utilize state financial management and technical assistance and may provide for periodic fiscal status reports to the state treasurer. The review team must report to the governor within 60 days of their appointment (a 30-day extension may be granted) whether a serious financial problem exists.

The review team's report must include one of three possible conclusions:

(a) A serious financial problem does not exist in the local government.

(b) A serious financial problem exists in the local government, but a consent agreement containing a plan to resolve the problem has been adopted pursuant to section 14(1)(c).

(c) A local government financial emergency exists because no satisfactory plan exists to resolve a serious financial problem.

The governor has a maximum of 30 days after receiving the report from the review team to make a determination that a serious financial problem does not exist in the local government; or a serious financial problem exists in the local government, but a consent agreement containing a plan to resolve the problem has been adopted; or a local government financial emergency exists because no satisfactory plan to resolve the serious financial problem exists. If a consent agreement is adopted, but the state treasurer or the review team informs the governor that the local government is not abiding by that agreement, the governor is required to declare that a financial emergency exists in the local government.

Appeal

If the governor determines that a financial emergency exists, he or she must provide the governing body and chief administrative officer of the local unit with a written notification of the determination, an explanation of the facts on which the decision was based, and notice that the chief administrative officer or the governing body of the local government has ten days to request a hearing conducted by the governor or the governor's designate. Following the hearing, or if no hearing is requested, the governor must either confirm or revoke the determination. If the decision is confirmed, the governor must provide a written report explaining the factual basis for the decision.

If the governor confirms that a financial emergency exists in a local government, that local government may appeal to the circuit court for the county in which the local government is located or to the circuit court for Ingham County. The court can only set aside the gubernatorial determination if it finds that the determination is either not supported by competent, material, and substantial evidence on the whole record or is arbitrary, capricious, or clearly an abuse or unwarranted exercise of discretion.

Emergency Financial Manager

If the governor determines that a financial emergency exists, he or she then assigns the responsibility for managing the local government financial emergency to the local emergency financial assistance loan board, which appoints an emergency financial manager (EFM). The EFM is chosen solely on the basis of competence and cannot have been either an elected or appointed official or employee of the local government for at least five years before the appointment. The EFM, who need not be a resident of the local government, serves at the pleasure of the local emergency financial assistance loan board. The emergency financial manager is entitled to compensation and reimbursement for actual and necessary expenses from the local government as approved by the local emergency financial assistance loan board. The EFM may hire staff and contract for professional assistance, after obtaining approval of the local emergency financial assistance loan board. Those costs are born by the local government.

In consultation with the local government, the EFM is responsible for developing and implementing a financial plan that balances expenditures with the EFM's revenue estimate and that pays debt service and other legal obligations when due. Both the plan and revenue estimates may be reviewed and revised as necessary by the EFM, and while the written plan is to be made public, it does not require public approval. The EFM is authorized by the statute to order officials or employees of the local government to take those actions necessary to implement the financial plan.

An emergency financial manager may assume the power and duties of the chief administrative officer and legislative body.

The EFM may renegotiate contracts, but may not abrogate contracts. The EFM is authorized to take any of the following actions:

(a) Analyze factors and circumstances contributing to the financial condition of the unit of local government and recommend steps to be taken to correct the condition.

(b) Amend, revise, approve, or disapprove the budget of the local government, and limit the total amount appropriated or expended during the balance of the financial emergency.

(c) Require and approve or disapprove, or amend or revise a plan for paying all outstanding obligations of the unit of local government.

(d) Require and prescribe the form of special reports to be made by the finance officer of the local government to its governing body, the creditors of the unit of local government, the emergency financial manager, or the public.

(e) Examine all records and books of account, and require the attendance of witnesses and the production of books, papers, contracts, and other documents relevant to an analysis of the financial condition of the local government.

(f) Make, approve, or disapprove any appropriation, contract, expenditure, or loan, the creation of any new position, or the filling of any vacancy in a permanent position by any appointing authority.

(g) Review payrolls or other claims against the unit of local government before payment.

(h) Exercise all of the authority of the local government to renegotiate existing labor contracts and act as an agent of the unit of local government in collective bargaining with employees or representatives and approve any contract or agreement.

(i) Notwithstanding the provisions of any charter to the contrary, consolidate departments of the local government or transfer functions from one department to another and to appoint, supervise, and, at his or her discretion, remove heads of departments other than elected officials, the clerk of the unit of local government, and any ombudsman position in the unit of local government.

(j) Employ or contract for, at the expense of the local government and with the approval of the local emergency financial assistance loan board, auditors and other technical personnel considered necessary to implement this article.

(k) Require compliance with the orders of the emergency financial manager by court action if necessary.

(l) Except as restricted by charter or otherwise, sell or otherwise use the assets of the unit of local government to meet past or current obligations, provided the use of assets for this purpose does not endanger the public health, safety, or welfare of residents of the unit of local government.

(m) Apply for a loan from the state on behalf of the unit of local government, subject to the conditions of the Emergency Municipal Loan Act, in a sufficient amount to pay the expenses of the emergency financial manager and for other lawful purposes.

(n) Approve or disapprove of the issuance of obligations of the unit of local government on behalf of the municipality, subject to the conditions of the Revised Municipal Finance Act, and the Revenue Bond Act of 1933,.

(o) Enter into agreements with other units of local government for the provision of services.

(p) Exercise the authority and responsibilities of the chief administrative officer and governing body concerning the adoption, amendment, and enforcement of ordinances or resolutions affecting the financial condition of the unit of local government as provided in the applicable acts.

(q) Reduce, suspend, or eliminate the salary, or other compensation of the chief administrative officer and members of the governing body of the unit of local government during the financial emergency. However, the EFM may not impair vested retirement benefits.

The EFM has 180 days after his or her appointment to determine whether possible criminal conduct contributed to the financial emergency. If the EFM determines that there is reason to believe that criminal conduct has occurred, he or she must refer the matter to the attorney general and the local prosecuting attorney for investigation.

Not later than 90 days after the completion of the emergency financial manager's term, the governing body of the unit of local government shall review any ordinance implemented by the emergency financial manager during his or her term, except any ordinance enacted to assure the payment of principal and interest on bonds.

Every six months, the EFM is required to file with the governor, the senate majority leader, and the speaker of the house of representatives, and to post on the local government's website, a report that contains all of the following:

(a) A description of each expenditure made, approved, or disapproved during the reporting period that has a cumulative value of $10,000.00 or more and the source of the funds.

(b) A list of each contract that the emergency financial manager awarded or approved with a cumulative value of $10,000.00 or more, the purpose of the contract, and the identity of the contractor.

(c) A description of each loan sought, approved, or disapproved during the reporting period that has a cumulative value of $10,000.00 or more and the proposed use of the funds.

(d) A description of any new position created or any vacancy in a permanent position filled by the appointing authority.

(e) A description of any position that has been eliminated or from which an employee has been laid off.

Liability

The law provides that the state, the members of the local emergency financial assistance loan board, and the emergency financial manager are not liable for any obligation of or claim against a local government resulting from actions taken in accordance with the statute.

Role of Local Officials under PA 72

As noted, an emergency financial manager may assume the power and duties of the chief administrative officer and legislative body. Elected officials of a local government are required to provide the assistance and information requested by a review team, the local emergency financial assistance loan board, or the emergency financial manager. Failure of an elected official of a local government to do so is considered gross neglect of duty, which the EFM must report to the local emergency financial assistance loan board. Following review and a hearing with the local government elected official, the local emergency financial assistance loan board may recommend to the governor that the governor remove the elected official from office. If the governor removes the elected official from office, the resulting vacancy in office is to be filled as prescribed by law.

Taxes

Neither the EFM nor the local financial assistance loan board has the power to impose taxes, over and above those already authorized, without the approval at an election of a majority of the qualified electors voting on the question.

Resolution

The emergency financial manager may or may not be able to resolve the financial emergency. If the EFM does resolve the problem, he or she would inform the local financial assistance loan board that the financial emergency has been solved. A recommendation by the EFM to revoke the determination of a financial emergency must be accompanied by the completed following form:

Local Government Emergency Financial Manager Exit Strategy Checklist

Issued under P.A. 72 of 1990 As Amended Local Unit of Government Type ☐ County ☐ City ☐ Twp ☐ Village ☐ Other	Local Unit Name	County
Date ☐ Consent Agreement ☐ Appointment of Emergency Financial Manager	Date of Completion of Exit Strategy Checklist	

In an effort to clearly set forth when the financial emergency has ended, the following checklist is to be used by the parties to document the end of the financial emergency and the end of the term of the Emergency Financial Manager. If all of the boxes are marked yes, the term of the Emergency Financial Manager shall be ended within the next 30 days.

Check each applicable box below.

	YES	NO	
1.	☐	☐	Has a written financial plan been developed in consultation with the local government?
2.	☐	☐	Does the written financial plan provide for the conducting of operations of the local government within the resources available according to the Emergency financial Manager's estimate?
3.	☐	☐	Does the written financial plan provide for the payment in full of the scheduled debt service requirements on all bonds, notes, and all other uncontested legal obligations of the local government?
4.	☐	☐	During the past 180 continuous days has the Emergency Financial Manager in consultation with the local government reexamined the Written financial plan?
5.	☐	☐	During the past 180 continuous days has the written financial plan been modified to conform to revised revenue estimates?
6.	☐	☐	During the past 180 continuous days have the operations of the local government been conducted within the available resources?
7.	☐	☐	During the past 180 continuous days have all scheduled debt service requirements on all bonds, notes, and other uncontested legal obligations been paid?
8.	☐	☐	Have all taxes withheld on the income of employees been transferred to the appropriate agency for the past 180 continuous days?
9.	☐	☐	Have all of the taxes collected by the local government as agent for another government unit, school district, or other taxing authority been transferred to the appropriate agency for the past 180 continuous days?
10.	☐	☐	Have all required pension, retirement, or other benefit plan contributions been made for the past 180 continuous days?
11.	☐	☐	Have all wages, salaries, or other compensation due to employees or retirees been paid for the past 180 continuous days?
12.	☐	☐	Have the total amount of accounts payable for the current fiscal year, as determined by the state treasurer's uniform chart of accounts, been less than 10% of the total expenditures of the local government for the past 180 continuous days?
13.	☐	☐	Have all deficits been eliminated in all funds for the past 180 continuous days?

In respect to any question to which the answer was "no," please provide an explanation as to why and indicate when the matter in question will be addressed or resolved.

Signature of Emergency Financial Manager:

_____

The governor may revoke the declaration of a financial emergency based a recommendation by the local financial assistance loan board.

If however, the EFM is unable to resolve the financial emergency, he or she may request approval from the local emergency financial assistance loan board to authorize the local government to proceed under Chapter 9 of Title 11 of the United States Code, 11 U.S.C. 101 to 1330. That notice to the local emergency financial assistance loan board must include a determination by the EFM that no feasible financial plan can be adopted that can satisfactorily resolve the financial emergency in a timely manner, or a determination by the emergency financial manager that an adopted financial plan, in effect for at least 180 days, cannot be implemented, as written or as it might be amended, in a manner that can satisfactorily resolve the financial emergency in a timely manner. The local emergency financial assistance loan board has 60 days to approve or disapprove the request. This is the only way a local government in Michigan can be authorized to file under Chapter 9 of the federal bankruptcy code.

Appendix B
Municipal Bankruptcy: Chapter 9, Title 11, of the United States Code

Commencing the Case

Municipal bankruptcy is initiated by the filing of a voluntary petition, a schedule of creditors, and a pleading. At the court's discretion, the list of creditors may be filed later if the debtor is initially unable to prepare it in the detail and form required by the court. The chief judge of the court of appeals for the circuit for the district where the case is filed assigns the bankruptcy judge for the case (in other kinds of bankruptcy cases, the clerk of the court makes the assignment).

Notice of the bankruptcy filing must be published at least once a week for three successive weeks in at least one general circulation newspaper in the district and in other newspapers having a general circulation among bond holders and bond dealers. Objections to the petition may be filed, and the court must hold a hearing on any objection. A petition may be dismissed if the court determines it was not filed in good faith or that it does not meet the requirements contained in the law. The court may also reject a petition for lack of prosecution, unreasonable delay, failure to propose a plan within the allotted time, material default, or other cause.

An automatic stay is implemented at the moment of filing, and if the petition is not dismissed and the case proceeds, that automatic stay prevents collection actions against the municipality, except for payment on revenue bonds. No creditor can demand payment, and no creditor can start or continue a legal action to recover debt. This gives the municipality time to negotiate a debt readjustment plan.

Federal constitutional law preserves the sovereignty, independence, and powers of local government bodies, and this protection remains under bankruptcy. In a municipal bankruptcy, local officials remain in power and, as noted, no federal receiver or trustee is appointed. Day-to-day activities of the municipality are not subject to court approval; the debtor may borrow money without court approval; and the debtor may employ professionals without court approval. Although no Michigan municipality has ever filed for bankruptcy, presumably the emergency financial manager would organize the filing and would remain in control of the municipality's finances and operations. The Michigan law is silent on this point.

Plan of Debt Adjustment

The municipality must file a plan of adjustment for its debts. This plan must be based on an analysis of cash flow and a determination of the validity and amount of claims. The plan classifies debts in accordance with priorities established in state and federal law, and provides a way that each class of claims can be adjusted (payment in full, payment over time, exchange, or rejection). Each class of claims votes for the plan of adjustment. Even without approval by the claimants, if a plan is proven to be feasible and in the best interest of creditors, it may be confirmed by the court. That confirmation releases the municipality from all claims not provided for in the plan, and the municipality emerges as a new entity.

In Chapter 9 cases, a creditors committee is appointed. That committee may employ attorneys, accountants, and other agents to represent creditors, consult with the debtor about the administration of the case, investigate the actions and financial condition of the debtor, participate in the formation of the plan of adjustment, and perform other services as required by the committee. Unlike corporate bankruptcy, there is no first meeting of creditors and creditors may not propose competing debt adjustment plans. However, all new projects of the municipality must be approved by a majority of creditors.

The municipality is permitted to adjust non-debt contractual arrangements under the power to reject executory contracts and unexpired leases, subject to court approval. The municipality may reject collective bargaining agreements and retiree benefit plans.

There are several general conditions that the plan of adjustment must meet:

- The plan must comply with applicable provisions of the bankruptcy law.
- All amounts to be paid must be fully disclosed and reasonable.
- The municipality is not prohibited by law from taking any action necessary to implement the plan.
- Except where a claimant has agreed to a different treatment, the plan provides that on the effective date of the plan, each holder of a particular class of claim will receive the amount allowed claimants in that class of claim.
- Any regulatory or electoral approval required for implementation must be obtained, or the provision is conditioned on obtaining that approval.
- The plan is in the best interests of creditors and is feasible.

The law requires that the plan of adjustment has been accepted by each class of claims that is impaired by the plan. Acceptance is not required if the class is not impaired. However, the court may approve the plan if at least one impaired class has accepted the plan. If only one impaired class accepts the plan, approval is still possible under the "cram down" provision, if all other requirements are met and the plan does not discriminate and is fair and equitable.

Chapter 9 allows parties in interest to appear, be heard, and object to the proposed plan. These may include representatives of the state, the Secretary of the U.S. Treasury, the Securities and Exchange Commission, municipal employees, employee organizations, local residents, non-resident owners of real property, affected creditors, securities firms, and local banks.

The court is limited to confirming or rejecting the plan of adjustment. The court cannot order the local government to increase its tax rates, even if revenues are not sufficient to pay creditors in full. Once the plan has been confirmed, the municipality deposits any consideration to be distributed according to the plan, and when that consideration has been certified by the court, the municipal debtor receives a discharge. The municipality emerges from the process as a new legal entity.[5]

[5] U.S. Courts at www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter9.html.