CRC Memorandum

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# Financial Emergencies in Michigan Local Governments

## Introduction

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**



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**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.

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## 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 contractu-

ally 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.