Study D-1100 March 20, 2001

Memorandum 2001-32

Municipal Bankruptcy (Discussion of Issues)

At the October 2000 meeting, the Commission reviewed general ideas for reform of California's obsolete and sketchy municipal bankruptcy statutes. The Commission heard the views of its consultant, Prof. Frederick Tung, and had before it the written comments of Henry Kevane. However, the Commission was reluctant to make basic policy decisions without some input and participation from representatives of local public entities and other interested persons.

We have received some assurances of interest and willingness to participate from several organizations, including California State Association of Counties, the County Counsels' Association, and the League of Cities. Thus, the staff has prepared an overview of issues raised in Prof. Tung's background study and Mr. Kevane's memorandum, as well as some other sources. At the March meeting, we intend to review these issues with a view toward making some basic policy decisions so that a draft tentative recommendation can be prepared.

Since the background study and other materials have already been distributed more than once, we have not reproduced them here. Prof. Tung's study was attached to Memorandum 2000-38 (April 29, 2000) and Memorandum 2000-66 (Sept. 29, 2000) (hereinafter "Tung Study"); commentary from Mr. Kevane was attached to Memorandum 97-19 (March 22, 1997), the First Supplement to Memorandum 2000-38 (June 21, 2000), and to Memorandum 2000-66 (hereinafter "Kevane Memo" — references are to the memo's original paging, not as renumbered in any of the reproduced copies). (These materials are available on the Commission's website at <ftp://clrc.ca.gov/pub/Study-D-Debtor-Creditor/D1100-BankruptcyCh9/>.) Memorandum 97-19 also forwarded excerpts from Amy Chang, "Municipal Bankruptcy: State Authorization Under the Federal Bankruptcy Code," Public Law Research Institute, Hastings College of the Law (1995) (also available online at <http://www.uchastings.edu/plri/fal95tex/muniban.html>).

BACKGROUND

Federal Law

Municipal bankruptcy law is covered by Chapter 9 of the federal Bankruptcy Code (Title 11) and related provisions. (See Tung Study at 4-5.) The fundamental purpose is to give municipal debtors a breathing spell through the automatic stay of collection efforts and to restructure municipal debt through formulation of a repayment plan with creditors. Forcing a repayment plan on nonconsenting creditors requires resort to the federal ability to impair contractual obligations under the Contract Clause. Unlike private bankruptcy law, however, municipal bankruptcy law must respect the sovereign power of the states over their subdivisions pursuant to the Tenth Amendment. Consequently, states have the power to control municipal access to bankruptcy and the bankruptcy courts have little power to intervene or direct the affairs of a municipal debtor that has filed for bankruptcy. The full extent of judicial authority in these cases, and the appropriate policies, are matters of debate, but are beyond the scope of the Commission's study, since they largely involve federal constitutional issues and the intricacies of the Bankruptcy Code. See, e.g., McConnell & Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425 (1993); Kordana, *Tax Increases in Municipal Bankruptcies*, 83 Va. L. Rev. 1035 (1997). The staff will also recommend that the Commission eschew studying and making recommendations to the Legislature concerning elaborate prebankruptcy municipal insolvency schemes or postbankruptcy intervention and trusteeship schemes.

Municipal bankruptcy law grew out of the financial crises of the 1930s. Chapter IX was created by an Act of May 24, 1934. After being held unconstitutional, Chapter IX was revised in 1938 and passed constitutional challenge, though little had changed but court personnel. It was made a permanent part of the Bankruptcy Act in 1946. The law was little used until the mid-70s. In 1976, further revisions were made in response to New York City's fiscal difficulties. Chapter 9 was incorporated into the new Bankruptcy Code in 1978. Additional revisions concerning state authorization of municipal bankruptcies were made in 1994.

California Statutory Framework

As noted, the federal municipal bankruptcy procedure dates to May 1934. The California Legislature responded quickly, enacting a detailed, uncodified

bankruptcy authorization, operative on September 20, 1934. See 1934 Cal. Stat. ch 4 (1st. Ex. Sess.). This act also purported to validate any municipal bankruptcy filings that occurred before it became operative. *Id.* § 7a. The 1934 act was replaced in 1939 with a more general authorization for any "taxing agency or instrumentality of this State" as defined in federal law to file a bankruptcy petition. See 1939 Cal. Stat. ch. 72 (operative April 21, 1939).

The general state statutes authorizing bankruptcy filings by local government were codified in 1949 and have never been amended:

> **Gov't Code § 53760. Authorization for local government to file**
>
> 53760. Any taxing agency or instrumentality of this State, as defined in Section 81 of the act of Congress entitled "An act to establish a uniform system of bankruptcy throughout the United States," approved July 1, 1898, as amended, may file the petition mentioned in Section 83 of the act and prosecute to completion all proceedings permitted by Sections 81, 82, 83, and 84 of the act.
>
> **Note.** References are to 11 U.S.C.A. § 401 (repealed); 11 U.S.C.A. § 403 (repealed; see now 11 U.S.C.A. § 903); 11 U.S.C.A. §§ 401-403 (repealed; see now 11 U.S.C.A. §§ 101 *et seq.*, 901, 902 *et seq.*, 903, 904, 921(b)).
>
> Section 84 had been repealed in 1946. See Pub. L. No. 481, § 2, 60 Stat. 409, 416 (1946).
>
> **Gov't Code § 53761. State consent**
>
> 53761. The State consents to the adoption of Sections 81, 82, 83, and 84 by Congress and consents to their application to the taxing agencies and instrumentalities of this State.

These sections are in Division 2 (Cities, Counties and Other Agencies) of Title 5 (Local Agencies) of the Government Code. There is another relevant provision in Division 4 (Financial Provisions) of Title 4 (Government of Cities), tied to refunding bonded indebtedness:

> **Gov't Code § 43739 (repealed). Authorization for municipal bankruptcy**
>
> 43739. Any city authorized to refund its indebtedness pursuant to this article may file a petition under any bankruptcy law of the United States. If the refunding of the city indebtedness is authorized in the bankruptcy proceeding, the city may refund its indebtedness pursuant to this article.

While not obsolete, the first sentence is redundant if there is general authority granted all municipalities. We have not yet found any legislative history on this provision.

There are a number of other general provisions relating to bankruptcy that are not defective, in the sense that they do not refer to obsolete federal law, but that should be reviewed to see whether technical amendment is appropriate. See Educ. Code § 41325; Gov't Code §§ 59472, 59110, 59125, 59598; Sts. & Hy. Code §§ 9011, 9075; Water Code §§ 24767, 25115. Whether it is profitable to clean any of them up will depend in part on the approach the Commission takes.

(For provisions specific to Orange County, see, e.g., Educ. Code §§ 42238.21, 84753; Gov't Code §§ 20487, 29141.1, 29530.5, 30400-30406, 53584.1, 53585.1; Health & Safety Code § 33670.9; Rev. & Tax. Code § 96.16; Sts. & Hy. Code § 2128. We do not propose to review these provisions.)

As indicated, references in the general Government Code sections have become obsolete following enactment of the federal Bankruptcy Code. The terminology is also inconsistent with the 1994 amendments providing that a "municipality" must be "specifically authorized" to petition for debt adjustment under Chapter 9:

> **11 U.S.C. § 109. Who may be a debtor**
>
> ….
>
> (c) An entity may be a debtor under chapter 9 of this title if and only if such entity —
>
> **(1) is a municipality;**
>
> **(2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;**
>
> (3) is insolvent;
>
> (4) desires to effect a plan to adjust such debts; **and**
>
> (5)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
>
> (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
>
> (C) is unable to negotiate with creditors because such negotiation is impracticable; **or**
>
> (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.
>
> ….

[Emphasis added.]

A state may not expand the authority permissible under this provision of federal law, but a state can limit the types of entities that can file, either by name or type, or by adopting a procedure for determining in each case whether the entity can file (discussed *infra*). As mentioned above, this system reconciles the constitutional principles of federal bankruptcy authority and state sovereignty.

MINOR AND TECHNICAL REVISIONS

Updating State Law — What Is a Municipality?

If the goal is to preserve California's historically broad grant of municipal bankruptcy authority, the simplest approach is to use the word "municipality" as used in federal law and thereby incorporate the broadest possible class of permissible filers. Any exceptions could be made as appropriate under the circumstances. Government Code Sections 53760 and 53761 continue to use language deriving from the 1934 emergency statutes — i.e., "taxing agency or instrumentality" — in describing entities authorized to file under Chapter 9. The law should be revised for consistency with the Bankruptcy Code, barring some purpose that we have not discovered to continue a limitation based on the concept of "taxing agency or instrumentality" of this state.

Incorporation of Federal "Municipality" Definition

Since the "taxing agency or instrumentality" language of Section 53760 uses a definition from the earlier Bankruptcy Act that has been replaced by the "municipality" language in Bankruptcy Code Section 109(c)(1)-(2), it would seem that the status quo can be maintained through a simple, mechanical update of Section 53760:

> 53760. Except as otherwise provided by statute, a municipality, as defined in 11 U.S.C Section 101(40), may file for bankruptcy protection and adjustment of debts pursuant to Chapter 9 of the federal Bankruptcy Code.
>
> **Comment.** Section 53760 supersedes former Sections 53760 and 53761. The former sections contained obsolete references to repealed federal bankruptcy law. This section provides specific authority to municipalities as defined in the federal Bankruptcy Code ("'municipality' means political subdivision or public agency or instrumentality of a State," 11 U.S.C. § 101(40)), to file under Chapter 9 (11 U.S.C. § 901 *et seq.*). This section continues the general substance of former law by granting broad authority commensurate with permissible filings under federal law. The introductory clause recognizes that the state may control access of its subdivisions and

> instrumentalities. See, e.g., Ins. Code § 10089.21 (California Earthquake Authority precluded from resort to bankruptcy). See also Educ. Code § 41325 (control of insolvent school district by Superintendent of Public Instruction).

Bankruptcy Code Section 101(40) defines "municipality" as a "political subdivision or public agency or instrumentality of a State." The effect of this definition is that the federal courts will determine whether a local governmental entity is a "municipality." This was one of the issues faced by the court in the Orange County Investment Pool case — as it turns out, the determinative issue. In *In re County of Orange*, 183, B.R. 594, 600-06 (C.D. Cal. 1995), the court decided that OCIP's Chapter 9 petition could not be sustained because OCIP was not a "municipality" or an "instrumentality of a State," nor was it otherwise "specifically authorized" by the language of Section 53760 and the incorporated parts of the repealed bankruptcy act. It is interesting to note that the court did not discuss the issue of whether Government Code Section 53760 was obsolete or imposed additional restrictions that might prevent OCIP's filing, but instead concluded that OCIP did not meet the requisite standards of old or new law. The OCIP court assumed that the municipality and state instrumentality language of the Bankruptcy Code could be applied, but found that OCIP did not qualify.

Legislative Intent Statement

Mr. Kevane has suggested that it might be useful to make clear that the authorization language is intended to satisfy the 1994 Bankruptcy Code amendments governing the nature of state authorization, which requires that the municipality

> is specifically authorized, in its capacity as a municipality or by name, to be a debtor under [Chapter 9] by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under [Chapter 9] ….

11 U.S.C. § 109(c)(2); see Kevane Memo, p. 5. This suggestion was implemented in some bills in the 1995-96 session. For example, AB 2xx (Caldera) provided in a new Section 53760(b):

> (b) It is the intent of the Legislature that this section specifically authorizes a municipality to be a debtor under Chapter 9 (commencing with Section 901) of Title 11 of the United States Code as required by Section 109 of that title.

The staff does not believe this statement of intent adds anything. The "specifically authorizes" language was intended to reject the line of cases under the prior statute holding that a grant of taxing authority in a state, without any specific grant of bankruptcy authority, served as a "general" authorization. We don't believe there has been much doubt that California is one of the specific authorization states, although the effective extent of the authorization is subject to some debate. See, e.g., Kordana, *Tax Increases in Municipal Bankruptcies*, 83 Va. L. Rev. 1035, 1044 (1997); Kupetz, *Municipal Debt Adjustment Under the Bankruptcy Code*, 27 Urb. Law. 531, 539-40 & n.24 (1995); Young, *Keeping a Municipal Foot in the Chapter 9 Door: Eligibility Requirements for Municipal Bankruptcies*, 23 Cal. Bankr. J. 309, 314-16 (1997); Comment (Freyberg), *Municipal Bankruptcy and Express State Authorization To Be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency and What Will States Do Now?*, 23 Ohio N.U. L. Rev 1001, 1008 n.66.

Definition by State Law

Mr. Kevane has argued that it would be better for the state to take control of the definitional issue by specifying which public entities can file under Chapter 9. See Kevane Memo, pp. 4-6. State law cannot expand the scope of federal bankruptcy law, but even if the purpose of listing types of entities is not to restrict access, a state catalog could be "a persuasive starting point for defining the scope of ["municipality"] in California. Moreover, the use of a sate law definition would reduce the risk that certain entities might be permitted or precluded from filing based on shifting federal interpretations of the term 'municipality.'" *Id.* at 7.

Professor Tung notes that this approach "has some promise but also some limitations." See Tung Study, pp. 31-32. He reminds that "only the federal definition matters. That definition cannot be expanded by state legislation, any more than any federal statute is subject to modification by a state legislature." He suggests:

> A list approach may be more effective. It would not redefine terms contained in the federal statute, but would merely provide a reference for the bankruptcy judge in her attempts to construe the terms "political subdivision" and "public agency or instrumentality" from federal law and decide whether a particular state-created entity qualifies. For example, some manifestation by the state that it considers a county-created investment pool to be a state agency or instrumentality might be persuasive.

The staff has opted at this stage to keep it simple, to update the language, but preserve the broad grant of authority without additional detail or complications. Mr. Kevane seems to suggest that the bankruptcy court in the OCIP case, in relying on laundry lists of entities from the 1930's and the lack of a specific state authorization for bankruptcy filing by a pooled investment fund, may have ruled too narrowly in rejecting the OCIP filing, and that a broader or more explicit list could have led the court to the right result. See Kevane Memo, p. 3. In the above quote, it appears that Prof. Tung shares this view to some extent. Does the Commission wish to include a state "laundry list" in the Chapter 9 authorization section? Or, assuming the broadest general authorization is desired, isn't it sufficient to incorporate the federal definition, perhaps with a statement of intent in the Comment (or in the statute)?

Risks of Specific Incorporation

It might also be objected that incorporation of the definition of "municipality" by reference to the relevant section in the Bankruptcy Code may become obsolete, just as the language codified in 1949 did by 1978 (one reference was obsolete even in 1949). But if the statute is going to use the federal definition explicitly, there is no infallible way to avoid potential obsolescence. We could add the clause "or as later amended" to cover renumbering, but some take the view that this type of reference to federal law is an improper delegation of state authority. The staff is not too concerned about the potential for obsolescence. The problem has really been that no one updated references globally in the California Codes when the Bankruptcy Code was enacted. That failure should not preclude appropriate references to federal law now. Broader references are possible, however, such as referring generally to all municipalities (or other appropriate phrase) permitted to file under Chapter 9, instead of referring to the definition in 11 U.S.C Section 101(40). This would avoid the need to make technical amendments if the definitions in Section 101 are renumbered or the terminology is changed.

Having some kind of specific reference is beneficial, in that it gives the reader a direct citation to the relevant federal statute, but the term "municipality" is not very enlightening to the non-specialist. On its face, it is not apparent that it would include school districts or mosquito abatement districts, or even counties. Perhaps nonspecialists should not expect to understand the meaning of this section. Those who need to know will do the appropriate research or engage the services of experts who can analyze the federal statutes and relevant cases to

understand what is covered. It might be useful to add something on the intention of the section, either in the section itself or in the Comment: "Incorporation of the definition of "municipality" [in subdivision (a)] is intended to authorize resort to Chapter 9 by the broadest class of public entities permissible under federal law."

Section 53761

Section 53761 should be repealed as unnecessary and redundant. See Tung Study, p. 6 n.20; Kevane Memo, p. 2 n.1. Put another way, if we were to attempt to salvage some of it, the staff is not clear on what could be saved. Bills in the 1995-96 session would also have deleted this section, as noted below. The staff would repeal this section:

> ~~53761. The State consents to the adoption of Sections 81, 82, 83, and 84 by Congress and consents to their application to the taxing agencies and instrumentalities of this State.~~
>
> **Comment.** Section 53761 is repealed. The section contained obsolete references to repealed federal bankruptcy law and is unnecessary in view of the general authorization provided in Section 53760.

Recent Bills

There have been some recent proposals that would have addressed the technical issues. Two bills before the Legislature in 1995-96 would have modernized the obsolete provisions. See SB 1274 (Killea); AB 2xx (Caldera). Neither bill made it out of committee. Both bills replaced Section 53760 with a new provision granting the broadest possible authority under the federal statute. SB 1274 also would have repealed Section 53761. A third bill — AB 29xx (Archie-Hudson) — would have modernized the authority provisions, but also required submission of the municipality's plan of adjustment to the "appropriate policy committees of the Legislature" before submission to the bankruptcy court. This bill also died. A fourth bill — SB 349 (Kopp) — repealed Sections 43739, 53760, and 53761, and replaced them with a gatekeeper committee (discussed *infra*). This bill passed the Legislature but was vetoed by Governor Wilson.

Definitional Limits on Authorization To File Under Chapter 9

As we have seen, California has historically provided broad access to municipal bankruptcy. Should access be restricted by limiting the "specifically authorized" municipalities? The staff is not proposing this alternative, but it needs to be considered.

With the proliferation of local government agencies — as many of 7000 of them who could claim municipality or instrumentality status — it may be important to consider limitations on the authority to file for debt adjustment. As Mr. Kevane posed the question: "Should a 'citrus pest control district' or a 'storm drainage district' be permitted to seek Chapter 9 relief?" See Kevane Memo p. 2. Conditions have changed dramatically since 1934 — there are significantly more special districts now than existed 65 years ago, while the number of counties remains the same and the number of cities presumably has not grown significantly. Historically, too, the special districts have comprised the bulk of the Chapter 9 filers. See, e.g., Tung Study, p. 22.

In 1996, the statute governing the California Earthquake Authority was amended to forbid resort to bankruptcy. Insurance Code Section 10089.21 (added by 1996 Cal. Stat. ch. 967 (SB 1993, Calderon)) contains the following language:

> 10089.21. The authority is a public instrumentality of the State of California and the exercise of its powers is an essential state governmental function. No provision of law … shall be construed to affect the status of the authority as a public instrumentality of the State of California. Notwithstanding any other provision of law, the authority is not and shall never be authorized to become a debtor in a case under the United States Bankruptcy Code (Title 11 of the United States Code) or to make an assignment for the benefit of creditors or to become the subject of any similar case or proceeding ….

There may be other provisions that we have not discovered. There are at least two trusteeship provisions, but they do not appear to prevent the affected entities (school districts, health care districts) from resorting to bankruptcy on their own. See Educ. Code § 41325(c); Health & Safety Code § 129173.

A revised Section 53760 could grant blanket authorization to certain types of municipalities, such as counties and charter cities, and apply conditions to other entities, or eliminate them entirely. There are any number of other combinations of authorizing standards that could be adopted.

There is some uncertainty inherent in relying on bankruptcy judges, as in the Orange County case, to determine whether an entity qualifies as a municipality, as has been discussed. Enacting a list of entities that may file might help clarify the law, but it can be a cumbersome task. We suspect the Commission would not want to attempt to pick and choose the authorized Chapter 9 filers, whether described by class or in particular.

All entities capable of bonded indebtedness are presumably listed in the validating acts. (For this year's bills, see SB 161, SB 162, and SB 163.) The list of entities includes:

> Air pollution control districts of any kind, air quality management districts, airport districts, assessment districts, benefit assessment districts, and special assessment districts of any public body, bridge and highway districts, California water districts, citrus pest control districts, city maintenance districts, community college districts, community development commissions, community facilities districts, community redevelopment agencies, community rehabilitation districts, community services districts, conservancy districts, cotton pest abatement districts, county boards of education, county drainage districts, county flood control and water districts, county free library systems, county maintenance districts, county sanitation districts, county service areas, county transportation commissions, county water agencies, county water authorities, county water districts, county waterworks districts, … agencies acting pursuant to Part 3 (commencing with Section 11100) of Division 6 of the Water Code, distribution districts of any public body, drainage districts, fire protection districts, flood control and water conservation districts, flood control districts, garbage and refuse disposal districts, garbage disposal districts, geologic hazard abatement districts, harbor districts, harbor improvement districts, harbor, recreation, and conservation districts, health care authorities, highway districts, highway interchange districts, highway lighting districts, housing authorities, improvement districts or improvement areas of any public body, industrial development authorities, infrastructure financing districts, integrated financing districts, irrigation districts, joint highway districts, levee districts, library districts, library districts in unincorporated towns and villages, local agency formation commissions, local health care districts, local health districts, local hospital districts, local transportation authorities or commissions, maintenance districts, memorial districts, metropolitan transportation commissions, metropolitan water districts, mosquito abatement or vector control districts, municipal improvement districts, municipal utility districts, municipal water districts, nonprofit corporations, nonprofit public benefit corporations, open-space maintenance districts, parking authorities, parking districts, permanent road divisions, pest abatement districts, police protection districts, port districts, project areas of community redevelopment agencies, protection districts, public cemetery districts, public utility districts, rapid transit districts, reclamation districts, recreation and park districts, regional justice facility financing agencies, regional park and open-space districts, regional

> planning districts, regional transportation commissions, resort improvement districts, resource conservation districts, river port districts, road maintenance districts, sanitary districts, school districts of any kind or class, school facilities improvement districts, separation of grade districts, service authorities for freeway emergencies, sewer districts, sewer maintenance districts, small craft harbor districts, stone and pome fruit pest control districts, storm drain maintenance districts, storm drainage districts, storm drainage maintenance districts, storm water districts, toll tunnel authorities, traffic authorities, transit development boards, transit districts, unified and union school districts' public libraries, vehicle parking districts, water agencies, water authorities, water conservation districts, water districts, water replenishment districts, water storage districts, wine grape pest and disease control districts, zones, improvement zones, or service zones of any public body.

BROADER REFORMS

Professor Tung has provided a concise overview of a number of approaches to state legislation on Chapter 9 bankruptcy, beyond the definitional or descriptive options already discussed. See generally Tung Study, pp. 21-31.

Gatekeeping

Historically, California has given broad access to municipal bankruptcy without any preconditions imposed as a matter of state law.

Governor as Gatekeeper

Largely because of the potential impact of unfettered municipal bankruptcy on statewide fiscal management, Prof. Tung proposes a state gatekeeper of some sort:

> Because municipal bankruptcy is not "free," resort to Chapter 9 should not be done casually. Moreover, because of the possible statewide spillover effects, local autonomy concerns must give way to statewide fiscal concerns, and objections to state involvement in the decision whether to resort to Chapter 9 should be discounted. Bankruptcy of a major municipality will almost certainly raise borrowing costs for other California municipalities and the state, and the bankruptcy process itself is expensive. These potential spillover effects suggest that *the decision to declare bankruptcy should not be left to the sole discretion of any municipality*. In the context of considering reforms to federal bankruptcy law, a working group report of the National Bankruptcy Review Commission asserted:

> It is simply "wrong" to allow a financially troubled municipality, whose problems reach and affect not only its own citizens and constituencies but affect others throughout the state, to unilaterally seek relief under the bankruptcy laws without prior authorization from the state within which it operates.
>
> Given that the costs of default will be borne by the state as a whole, and given the connection between state allocations and local budgets, the state government should have the opportunity to consider whether bankruptcy is the best approach to the problem. While bankruptcy *might* be the best of a number of unattractive alternatives, and perhaps the costs of municipal default *should* be spread throughout the state under some circumstances, that decision is essentially a political one that implicates the entire state. A distressed municipality should not be authorized to decide the question unilaterally. For similar reasons, conditions imposed on a filing municipality should not be inhibited by home rule concerns when a fiscal crisis will have statewide impact. Trusteeship provisions were ultimately enacted in connection with the Orange County bankruptcy, and my proposal incorporates the possibility of similar mechanisms.

Tung Study, pp. 16-17 (footnotes omitted).

Although he recognizes that involving state officials may create some confidentiality risks before the filing, he believes the mechanism could be structured to minimize the risk. *Id.* at 20. Ultimately, Prof. Tung settles on the Governor as the best gatekeeper:

> The basic premise of my proposal is that the governor must authorize any municipal bankruptcy filing. The governor should also have wide latitude to attach conditions to the bankruptcy authorization. In terms of setting conditions, the governor should have a short menu of well-defined options at his disposal, including the possible appointment of a trustee to manage the municipal entity through its financial crisis.
>
> My approach attempts to encourage and facilitate cooperation between the state and the distressed municipality. Rather than empowering the governor to dictate terms to a municipality in trouble, it will encourage early communication between the two and a negotiated resolution of any financial crisis.

Id. at 24-25. (For the full exposition of Prof. Tung's proposal, you should review the Study at pp. 24-31.)

State Fiscal Committee as Gatekeeper

As noted elsewhere, Senator Kopp worked a bill through the Legislature in the 1995-96 session — in the midst of the Orange County debacle. SB 349 established a "Local Agency Bankruptcy Committee" (LABC) consisting of the Controller, Treasurer, and Director of Finance to determine whether to permit a municipality to file a Chapter 9 petition. It also contained provisions concerning appointment of a trustee by the Governor and time periods for various actions. The bill was vetoed by Governor Wilson on September 30, 1996. The veto message stated that the bill

> would inappropriately vest responsibility for local fiscal affairs at the state level, creating an instrument of state government to usurp the authority of local officials to decide the wisdom of a bankruptcy filing" and "could raise questions of the liability of the state to creditors of the public agency if eligibility for bankruptcy is denied.

Gatekeeper Conclusion

The staff believes Prof. Tung has offered a sound approach that recognizes the issues and risks and attempts to address them. He has favored flexibility and simplicity, while keeping in mind the goal of reducing the risk of fiscal damage beyond the insolvent municipality's orbit. We think his judgment that the Governor is the most appropriate official is sensible, but, as reported in Memorandum 2000-66, we have learned informally that the Governor's Office is not particularly interested in having the gatekeeper function. Whether this dooms gatekeeping proposals in general is hard to assess. Whether the committee approach in Senator Kopp's SB 349 would be advisable is hard to judge. The more people serving as gatekeepers, the less likely it is that needed confidentiality can be maintained and that swift approval can occur when necessary.

Despite the appeal of the gatekeeper to protect state fiscal interests, the staff has concluded that minor bankruptcies of special districts and school districts can be tolerated without the need for gatekeeping and that the large crises, like Orange County, may of necessity require complicated political solutions and that we are not likely to be able to fashion an acceptable procedure in advance that can deal with future major insolvencies.

Trusteeship

Kevane Proposal

Henry Kevane has proposed a post-filing trusteeship scheme as an alternative to a gatekeeper scheme. See Kevane Memo, pp. 6-10. A trustee could be appointed by the Governor when a public entity had filed a Chapter 9 case and would have all the powers of the entity, including powers under Chapter 9. The statute would permit appointment of a trustee

> if the Governor or his or her designee determines that (a) the public body is or will be unable to provide essential health, safety or welfare services to its constituents, (2) the financial status of the public body may jeopardize the ability or increase the costs of the state or its political subdivisions to issue debt or borrow money, (3) the principal creditors in the Chapter 9 case have failed to reach substantial agreement on the terms of a plan of adjustment, (4) the timely confirmation of an acceptable plan of adjustment appears unlikely, or (5) the appointment of a trustee is otherwise in the interests of the state, its residents and other public bodies within the State.

Id. at 10. Mr. Kevane believes that it is important to give the municipality the benefit of the automatic stay upon filing under Chapter 9 and that the correct focus is on shaping the adjustment plan and other fiscal matters (or dismissing the petition) once the factors can be better known:

> I think it is important to separate the *access* issue (who **can** file) from the *process* issue (who **should** file). In my view, the former should be an easy, speedy and non-politicized decision that balances only the interests of the taxpayers, creditors and employees of the municipality. The latter should be the arena for the State's interest to come into play, **after** the full extent of the municipality's problems can be dispassionately analyzed and creditors have been organized and informed.

Memo 2000-66, Exhibit p. 1. Both Prof. Tung and Mr. Kevane are concerned about the potential impact of municipal bankruptcy on broader interests of the state and other entities, but they differ on how best to deal with the problem.

Trusteeship Conclusion

The staff finds Mr. Kevane's proposal to be quite appealing, although we would hazard a guess that if the Governor's Office doesn't want to serve as a gatekeeper, the post-filing role envisioned in the Kevane trusteeship proposal may also be unwanted. The proposal was directed to Senator Kopp as an

alternative to his Local Agency Bankruptcy Committee (Controller, Treasurer, Director of Finance) gatekeeper proposal in SB 349 (1995-96). Mr. Kevane notes that trustees are used in some specialized areas, such as school district insolvency (as noted elsewhere). Clearly the Legislature is aware of the possibility of using trustees in this fashion. Whether a trusteeship approach would help meet the objections of local government evidenced in Governor Wilson's veto of SB 349 is unknown.

As to the point of getting a quick automatic stay, the staff does not think this is too important in Chapter 9, as opposed to other bankruptcy procedures. Bondholders should be aware of the financial condition of the municipal debtor, so there shouldn't bee too much of a surprise possibility. Furthermore, the normal creditors' remedies do not apply to municipalities, lessening the importance of the automatic stay.

State Insolvency Procedures

There is a great deal of law governing municipal finances. One approach to the overall problem of municipal insolvency would be to examine this law and consider alternative schemes, including elaborate procedures enacted in other states (such as Pennsylvania) for working out municipal insolvency before bankruptcy. The staff recommends against the Commission taking this approach because, notwithstanding the potential merits of state prebankruptcy insolvency procedures, this would be a terribly complicated project, far outside the staff's competence, and probably would not be welcomed by the stakeholders.

Professor Tung notes that state involvement could avoid the need to resort to bankruptcy. See Tung Study, p. 18. In fact, his proposal for state gatekeeping is intended to encourage and facilitate approaches to deal with insolvency short of bankruptcy. See *id.* at 25-31. In fashioning his proposal, however, he has avoided elaborate nonbankruptcy schemes:

> In contrast to these elaborate nonbankruptcy schemes, my proposal is less formal, less elaborate, and less aggressive than these other state systems. Because it is based on bankruptcy authorization, the system I propose is formally triggered only by a municipal entity's application for bankruptcy authorization and its subsequent bankruptcy filing. By contrast, some states' municipal distress systems include objective triggers of financial distress that enable early unilateral state intervention. I believe a more informal approach is appropriate for California. States that have elaborate state intervention provisions, like Michigan and Pennsylvania,

> typically anticipated multiple municipal crises as a result of general economic downturns and declining tax bases in their respective regions. Without prompt and active intervention by the state, successive municipal crises could have had severe statewide ramifications. In California, by contrast, municipal financial distress is quite rare, especially for general purpose municipalities.

Id. at 31.

CONCLUSION

Four years ago, the staff concluded that it was not "profitable for the Commission to simply recommend legislation to update Section 53760." (Memorandum 97-19, p. 7.) This was based on the then recent failure of two bills that would have make such technical revisions. The staff also concluded in 1997 that the law was "seriously in need of review, both substantively and technically.… Our only hesitation, and it is a most serious one, is whether this area is too highly politicized to benefit from the Commission's involvement."

With Prof. Tung's excellent background study and Henry Kevane's valuable 1996 memorandum, along with other staff research, we have done a fair bit of review. As the Commission knows, however, we do not find a consensus. One problem is that, far from being in a political crossfire, we have not elicited much stakeholder interest in the subject at all. We suspect, though, that the situation would be different if a bill were introduced to implement one of the substantive proposals before the Commission.

The staff tends to favor the gatekeeper approach as outlined by Prof. Tung, but we believe that neither local entities nor the Governor will support this proposal. We don't know whether Mr. Kevane's trusteeship proposal would fly; it might be opposed by the same parties. And although it has been over four years since Senator Kopp's SB 349 was vetoed by Governor Wilson, we remain concerned that a bill restricting access based on a gatekeeper approach may still be "too political." Weighing the factors discussed by Prof. Tung and Mr. Kevane is largely a political exercise: what is the state's interest in controlling access as a gatekeeper, what is the risk to the fiscal soundness of the state and its subdivisions by unrestricted access to Chapter 9, who can and should step in to remedy insolvency and when should they do it. As we have seen in the Orange County crisis, the state does respond, albeit reactively. And in other instances, as with school districts, there are mechanisms in place for the state to use a trustee

mechanism. Finally, there are a host of statutes governing municipal finance that also serve to avoid insolvency and promote sound credit.

In light of the political factors and the lack of a consensus, **the staff does not believe it is profitable to attempt a revision beyond the technical cleanup** — at least for now. Conditions may change, and the background study and other materials should be of significant assistance in fashioning a recommendation at the appropriate time.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary