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Bankruptcy for Strapped Cities, Counties?

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LOS ANGELES A combination of reduced tax revenues, high unemployment, a struggling state government and increasing pension costs are squeezing California municipalities.

The budget deal reached by legislators and the Governor late Monday only promises to make things worse. The Los Angeles Board of Supervisors has moved to sue the state, saying the proposed budget would cut as much as \$24 billion in tax revenues from the county's coffers over the next 30 years and another \$2 billion over the next two years alone if the state moves ahead with a separate plan to take highway funds.

"State spending and significant tax giveaways, among other things, have brought us to this precipice," said the motion, authored by Supervisors Zev Yaroslavsky and Don Knabe, which passed 4-0.

But is the situation bad enough to push the state's local governments the way of Vallejo, which last year filed for bankruptcy protection?

Daniel S. Schechter, a professor at Loyola Law School, said the state ripping off the property tax revenue and income tax revenue could create "a cascade effect."

Not only will cities and counties have less money, but they have to make it go further. Unemployment and underemployment have greatly increased demand for services from people who can't pay for them, Schechter said, and increased the number of people who are at or below the poverty level.

But he conceded that whether that would push municipalities into insolvency is "all speculative at this point."

The reason it's speculative is because local governments have a lot of options for dealing with cash-strapped times.

Chapter 9 of the federal bankruptcy code is a last-gasp tool for municipalities to stave off ruin by reorganizing debt and allowing the renegotiation of labor agreements, among other provisions.

After Congress rewrote the bankruptcy statute in response to the Great Depression, states were given the choice of opting into the new system. California passed a 1949 law that gave local governments the green light to apply for Chapter 9 bankruptcy protection.

Only three state municipalities have done so.

Orange County filed for Chapter 9 protection in 1994 after it suffered a series of massive losses in an investment pool run by the county treasurer.

The small Riverside County community of Desert Hot Springs filed in 2001 after it was unable to pay approximately \$3.1 million of a judgment as well as additional legal fees and court costs in a housing discrimination lawsuit.

Vallejo's filing in 2008 was the end product of its inability to pay its pension funds as well as the long-term effects of the 1996 closure of the Mare Island Naval Shipyard.

"Municipalities even more so than business entities have lots of ways to defer confronting short falls," said Bruce S. Bennett, a partner at Hennigan, Bennett & Dorman, who, along with Johnston, represented Orange County during its bankruptcy.

Local governments have the ability to borrow from different funds that are normally separated for a different purpose, Bennett said. They also engage in budget cuts, borrowing and moving transactions between fiscal years, he added.

Those measures can typically keep municipalities afloat during lean times.

"This happens in every economic cycle," Bennett said. "In most prior cycles, when municipalities borrow and use fiscal year boundaries to solve budget problems, the economy recovers and they can repay loans and reverse or remedy transfers across fiscal year boundaries."

Orange County's bankruptcy went relatively smoothly, due in part to the beginning of the prosperous Clinton years, said James O. Johnston, a partner at Hennigan, Bennett & Dorman in Los Angeles who specializes in municipal bankruptcies and who also worked on the Orange County case.

"The capital markets were more favorable [then]," Johnston said.

"You definitely have a different situation with the debt markets now," he added. "There are a number of entities out there with unsustainable balance sheets."

The collapse of the housing market and the credit crunch have hit California hard and left county governments at the mercy of legislators in Sacramento, who are on the road to making punishing cuts in services to close an approximately \$26 billion deficit. Municipalities burdened with expensive pension plans for its workers are also facing big fiscal worries, observers said.

Favorable state employee contracts, large pension obligations and severely under-funded pension plans have put California cities and counties in a difficult position, Johnston said.

Generous benefit packages and relatively high pay scales for some city and county workers have played a role in the financial meltdown and will cause some leaders to make "hard political choices," he added.

The length and depth of the recession will determine whether Chapter 9 protection is utilized more.

But even those municipalities that consider it can wait a long time. San Diego reportedly has discussed bankruptcy for years in response to a pension-funding problem, but it hasn't pulled the trigger.

If there's one issue that trumps finances, it's politics.

"Public officials who are faced with this question don't want to do it," said Dwight Stenbakken, deputy executive director of the League of California Cities. "It's tremendously embarrassing. It's usually the end of a political career on the city council."