

The Vanishing City:

Is Disincorporation a Solution for Struggling Cities?



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History of Disincorporation

- **Seventeen Cities have disincorporated in California**
- **Only one under LAFCO statute (Cabezon)**
- **Only one other since 1963 (Hornitos – by special statute)**
- **Current Proposal to Disincorporate Vernon (AB 46/AB 781)**
- **Disincorporation has been suggested as an alternative to bankruptcy for stressed cities**

Methods of Disincorporation

- **Statutory**
 - Specific to individual City
 - Most flexibility (But still subject to Contracts Clause)
 - Subject to Legislature and Governor Approval
- **Under Cortese-Knox Act**
 - Established Procedure
 - Gives LAFCO Significant Control
 - Subject to Local Voter Approval
 - Statute outdated (re taxes)

Legal Effects of Disincorporation

- **No impairment of contracts**
- **Effect on Bondholder Security**
- **Labor Agreements**
- **Funds transferred to Special Fund of County**
- **Assets transferred to County**
- **Former City's Tax Levies**

Impairment of Contracts/Bondholder Security

- **All legislative acts subject to federal Contracts Clause**
- **Prohibition is not absolute (balancing test)**
- **Bonds most tightly protected**
- **LAFCO Act does not permit impairment or discharge of liabilities**
- **Security features must stay in place**
 - Real Estate/Lease Financing
 - Special Tax pledge
 - Pledged Funds
 - Covenants to secure bonds (rate covenants, covenant to operate facility, etc.)

Labor Agreements

- **Are They Contracts?**
 - *Glendale* says MOUs are binding and enforceable
 - Section 56886 says LAFCO may modify or terminate terms
 - *Sonoma* says CBAs are protected by Contracts Clause
 - “Impairment” vs. simple breach – Claims against remaining funds?
- **Political Considerations**
- **Transfer of Employees to County (or new district) employment**

Existing Funds and Assets

- Funds to County Special Fund (for wind-down)
- Assets to County (subject to encumbrances such as leases)
- County is successor to former city's claims (can sue and collect)
- Surplus funds (if any) to provide services to former city territory

Former City Tax Levies

- ***Ad valorem* tax to County (or possibly to new district?)**
 - Act requires county to levy additional *ad valorem* property tax if necessary, but now unconstitutional under Proposition 13
- **Other taxes**
 - Levied, but uncollected taxes, to special fund
 - What about continuation of non-*ad valorem* taxes?
 - What about other taxes levied in unincorporated area?
- **Utility systems – county may take over**
- **Special Assessment districts – Stay in Place**

Steps for Disincorporation under the Act

- **Initiation by Petition or Resolution**
- **LAFCO Consideration/Hearing**
- **Election**
- **Completion of Proceedings**

Initiation of Proceedings

- **LAFCO cannot self-originate**
- **Petition**
 - Must comply with Statutory requirements (56652, 56670)
 - Must be approved in advance by LAFCO
 - Must be signed by 25% of Registered Voters (very high standard)
- **Resolution**
 - May be by city, county or other affected local district
 - Same Requirements as Petition, plus
 - Provide plan for providing services and financing them

LAFCO Hearing Process

- **Hearing must occur within 90 days of completed petition/resolution**
- **May continue for up to 70 days**
- **Decision within 35 days of conclusion of hearing**
- **If disapproved, no more proceedings for one year**
- **If approved, may be petitioned for reconsideration**
- **If approval final, proceed to election**

LAFCO Powers

- **LAFCO may impose “virtually limitless array of factors”**
- **Conditional Approval possible**
 - On enactment of new taxes (but requires voter approval)
 - On approval of alternative district/CSA
 - May be up to 6 month delay for satisfaction of conditions
- **No violation of Act requirements**
- **No impairment of creditors**

Election

- After approval by LAFCO, disincorporation must be approved by voters
- Majority vote required
- No election if majority protest (very unlikely)
- May be by mailed ballot
- Normal election rules apply

Completion of Proceedings

- **Certificate of Completion within 30 days of Canvass**
- **Certificate of Satisfaction of Conditions within 90 days of election**
- **Effective Date within 9 months of election (but not before certificate of completion/satisfaction)**

Problems with Disincorporation

- Complexity – especially for larger city
- Need to Cover all debts/creditors
- Loss of non-ad valorem tax revenues?
- Ongoing services must be paid for somehow
- Political Issues (public employee unions, other vested interests)

Need for Disincorporation

- **Large unmanageable debts**
 - Capital markets related
 - Judgments
 - Investment losses
- **Unsustainable fiscal situation**
 - Loss of tax base
 - Increasing labor costs
 - Loss of economic base
- **Political dysfunction/corruption**

Municipal Bankruptcy and Disincorporation?

- **Can chapter 9 be used in combination with disincorporation?**
 - Creates a “chapter 7 for municipalities”
- **Adjust debts as precursor to disincorporation**
- **Reject burdensome contracts**
 - Leases and other contracts
 - CBA’s
 - Post employment obligations
- **Reduce claims to amount of special fund assets**
- **Reduce ongoing obligations**

How Liquidation Might Work

- **Chapter 9 Plan**
 - Disincorporation as element of plan
 - Plan effectiveness conditioned on disincorporation
 - Very difficult with hotly contested case
- **LAFCO conditions of approval**
 - Dovetail with chapter 9 plan
 - Disincorporation effectiveness conditioned on approval of plan
- **Timing problems**
 - Time limitations on LAFCO action
 - Unpredictability of bankruptcy court process/appeals

Conclusion

- **There is a reason there have been so few**
- **In fiscal stress situations, may be impossible without a bankruptcy**
- **Alternatives exist**
 - Contracting out
 - Consolidation of cities
 - Shared services arrangements