The Vanishing City:  
Is Disincorporation a Solution for Struggling Cities?

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presented by  
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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  - Statute outdated (re taxes)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
Local Agency Re\textsuperscript{Re}Formation
in Our Troubled Financial Times

California Association of Local Agency Formation Commissions
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Why Do Cities Struggle Financially?

Chronic dysfunction (widespread):
1. Local revenue risk and uncertainty.
   - state actions  - local economic conditions
2. Tax structures out of step with changing society:
   - sales tax, - hotel tax, - gas tax, - utility user tax
3. Fragmentation of local finance and governance among overlapping governments.
4. Disconnect between service costs and revenues in urban development. (Fiscalization of Land Use)

Acute distress:
2. Unsustainable employee compensation levels – especially public safety employee retirement benefits.
3. Court judgments – e.g. land use
Warning Signs of Local Agency Terminal Illness

1. Severe chronic - becoming acute - unaddressed capital improvement needs, threatening health & safety: 
   = roads = drainage = water = sewer
2. Cuts of public safety services below essential levels:
   = law enforcement = fire suppression
3. General Fund reserves below 1% of total annual general operating funds.
4. Adverse opinion or going concern qualification by independent auditor.
5. Withdrawal by independent auditor from audit engagement.
6. Inability to procure independent auditor.
7. Downgrade of outstanding bonds to below investment grade.
8. Default in bond payment or violation of one or more bond covenants.
9. Employees have not been paid for 7 days after scheduled payment date.
10. Has not deposited minimum pension fund obligation as required by law.
SB89 (2011)
Fiscal Poison for City Incorporations and Inhabited Annexations

A Little History...
The VLF-Property Tax Swap

State General Fund

$4.4 b

State

$4.4 b

Schools

$4.4 b

in FY2004-05

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Vehicle Lic Fee $ Allocation
Prior to 2004

Existing City

$ VLF (including backfill)

Annexation

New City

7yr "Bump" $ VLF

Vehicle Lic Fee $ Allocation
With PropTax – VLF Swap of 2004

Existing City

$ PropTax in lieu of VLF

Annexation

New City

Incorporating After 2004