

RE: Local Government and School District Fiscal Accountability Act
FROM: Paul Zorn
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On March 16, 2011, Michigan Governor Rick Snyder signed the Local Government and School District Fiscal Accountability Act (PA 4 of 2011). The stated intent of the Act is to safeguard and assure the fiscal accountability of local governments and preserve their “capacity to provide necessary public services essential to the public health, safety, and welfare.” Given that citizens would be adversely affected by local government insolvencies, the Act finds that the state has a valid public purpose in assisting local governments to remedy conditions of financial stress or emergency. Under the Act, this is addressed by requiring prudent and efficient fiscal management, permitting the restructuring of contractual obligations, and prescribing the powers and duties of state and local government officials and emergency managers.

Emergency management legislation is not new to Michigan and legislative efforts to prevent or alleviate local government financial crises date back to the Uniform Budgeting and Accountability Act (PA 2 of 1968), if not earlier. In 1990, the Local Government Fiscal Responsibility Act (PA 72 of 1990) specifically addressed state procedures for determining whether a local government was in a financial emergency, the process by which an emergency manager was chosen, and the roles and responsibilities of the emergency manager.¹ However, the 2011 legislation repealed the 1990 legislation and provides state officials and emergency managers considerably more latitude in responding to financial emergencies.

Determining a Financial Emergency

The process of declaring a financial emergency begins with a preliminary review of the local government by the state financial authority (SFA).² This review may be triggered by a number of events, including (but not limited to):

- a written request for review by the governing body or chief administrative officer of a local government;
- a written request from a creditor with an undisputed, unpaid claim against the government amounting to the greater of \$10,000 or 1% of the government’s general fund budget;
- a petition containing specific allegations of financial distress signed by at least 5% of the total votes cast for all candidates for Governor within the jurisdiction in the last election;
- written notification that the local government has not paid its minimum pension fund payment as required by law;
- written notification the local government has failed to pay compensation owed to employees or benefits owed to retirees; and
- a resolution from either the Michigan Senate or House requesting the review.

For the most part, the trigger events described above were also included in the 1990 legislation. However, the 2011 legislation added some additional triggers, including:

¹ Citizens Research Council of Michigan, *Financial Emergencies in Michigan Local Governments*, Report 362, April 2010.

² For Michigan municipalities, the SFA is the State Treasurer. For school districts, the SFA is the Superintendent of Public Instruction.

- a breach of the local government's obligations under a deficit reduction plan;
- a decline in the local government's long-term bond rating by one or more credit rating agencies to BBB or its equivalent; and
- at the State Treasurer's sole discretion (or the sole discretion of the Superintendent of Public Instruction in the case of school districts), given certain facts and circumstances.

This last item gives the State Treasurer (or the Superintendent of Public Instruction) considerably more latitude than the 1990 legislation.

Once the SFA decides that a preliminary review is appropriate, it begins the review and notifies the local government. A review team is appointed by the Governor and consists of the State Treasurer (or designee); the Director of the Department of Technology, Management, and Budget (or designee); a nominee of the Senate Majority Leader; a nominee of the House Speaker; other state officials as appointed by the Governor; and the Superintendent of Public Instruction, if the entity is a school district.

The review team is staffed by the Department of Treasury and has 60 days to complete the review, which includes meeting with representatives of the local government and examining its books and records. If necessary, the Governor may grant a 30-day extension of the 60-day limit.

The review team also has the power to negotiate and sign a consent decree with the chief administrative officer of the local government, establishing the remedial actions necessary to address the financial problem. The consent decree may include a "continuing operations plan" or a "recovery plan." To become effective, the consent decree must be approved by the local government's governing body and the SFA. The State Treasurer is authorized to place the local government into receivership in the event of a material breach of the consent decree.

In reporting its findings, the review team is required to come to one of the following conclusions: (1) the local government is not in financial stress or is in mild financial stress; (2) the local government is in severe financial stress, but a consent agreement has been adopted; (3) the local government is in severe financial stress, but no consent agreement has been adopted; or (4) a financial emergency exists with no satisfactory plan to resolve the emergency.

Process for Responding to a Financial Emergency

After receiving the review team's report, the Governor has 10 days to determine whether the review team's conclusion is correct. If the Governor decides that a financial emergency exists, he or she must notify the local government's governing body and chief administrative officer and provide a written report explaining the determination. The local government may request a hearing, which would be conducted by the SFA or the SFA's designee. If the finding of financial emergency is upheld at the hearing, the local government can appeal the finding to the Ingham County Circuit Court, by a 2/3rd vote of its governing body. However, under the 2011 Act, the circuit court cannot set aside the determination unless it finds that the determination is either: (1) not supported by competent, material, and substantial evidence; or (2) arbitrary, capricious, or clearly an abuse or unwarranted exercise of discretion.

If the determination of financial emergency is upheld, the Governor must declare the local government in receivership and appoint an emergency manager. The emergency manager acts in the place of the local government's governing body and chief administrative officer and has broad powers. Once the local government is in receivership, the governing body and chief administrative officer may not exercise the powers of their offices unless permitted in writing by the emergency manager.

To be qualified, the emergency manager must have at least five years of experience and demonstrable expertise in business, financial, or state and local budgetary matters. The emergency manager must be an individual, but need not be a resident of the local government. The emergency manager serves at the pleasure of the Governor, but may be impeached by the legislature.

The emergency manager's compensation is paid by the local government as set forth in a contract approved by the State Treasurer. The emergency manager may hire additional staff and consultants as he or she considers necessary. The local government must also agree to pay any legal bills incurred by the emergency manager.

Under the Act, a local government in receivership is considered to be in a condition of financial emergency until the emergency manager declares the financial emergency to be over and the State Treasurer concurs (or the Superintendent of Public Instruction concurs, in the case of a school district).

Roles and Responsibilities of the Emergency Manager

The primary task of the emergency manager is to develop a financial and operating plan for the local government to resolve the financial emergency and provide the governmental services essential to public health, safety, and welfare. This includes:

- conducting all aspects of the local government's operations within available resources;
- paying all debt service on the local government's bonds, notes, and other legal obligations;
- making timely payments to the local government's pension fund; and
- any other actions the emergency manager considers necessary to alleviate the financial emergency (for school districts, the emergency manager's authority extends to making changes to the academic or educational plan).

A key change in the 2011 legislation is the expanded power that the emergency manager has over contracts under Section 19(1)(k). Under this section, the emergency manager may reject, modify, or terminate one or more conditions of an existing collective bargaining agreement, after meeting with the appropriate bargaining representative.³ This would be considered a legitimate exercise of the state's sovereign powers under the Act if the emergency manager and the State Treasurer determine that all of the following conditions are satisfied:

- the fiscal emergency has created a circumstance where it is reasonable for the state to intercede;
- any plan to reject, modify, or terminate one or more terms of an existing bargaining agreement is reasonable and necessary to deal with a broad, generalized economic problem;
- the plan is directly related to the financial emergency and benefits the public as a whole; and
- the plan is temporary and does not target specific classes of employees.

³ However, the emergency manager is not allowed to change collective bargaining provisions for duty-related death benefits for police officers or firefighters.

In their analysis of the Act, the Citizens Research Council of Michigan (CRC) calls the emergency manager's expanded power over contracts "possibly one of the most contentious changes" in the Act.⁴ The CRC report points to Article 1, Section 10 of the Michigan Constitution of 1963 which states: "No bill of attainder, ex post facto law or law impairing the obligation of contracts shall be enacted." The CRC goes on to say that, as a practical matter, "if any contract for goods and services could be broken by a state appointed financial manager, the vendor's risks associated with that agreement would be dramatically increased, potentially raising the cost of doing business for every municipality and school district in the state."⁵

Another key change in the 2011 legislation is that it gives the emergency manager new authority over local government pensions under Section 19(1)(m). Under this section, the emergency manager has the power to become the sole trustee of the local government's pension fund if the pension fund is not at least 80% funded (excluding the net value of pension bonds or other related indebtedness). If the emergency manager becomes the sole trustee, the following would apply:

- the emergency manager would assume the authority and fiduciary responsibilities of the pension board, including setting and approving all actuarial assumptions;
- the emergency manager would be required to comply with the state's Public Employee Retirement System Investment Act and Article 9 Section 24 of the Michigan Constitution;
- the emergency manager would be allowed to make changes to the local pension fund, provided he or she identified the costs and benefits of the changes and received the State Treasurer's approval. (Moreover, if such changes involved transferring the local pension funds to another pension fund, the fund receiving the transfer would have to be at least 80% funded.); and
- the emergency manager's authority over the pension fund would end not later than the termination of the local government's receivership.

Recent Legal Challenge

On April 18, 2011, Detroit's two retirement systems, the General Retirement System and the Police and Fire Retirement System, filed suit against the Act in U.S. District Court, naming the Governor and State Treasurer as defendants. Specifically, the complaint charges that a portion of the Act would: (1) impermissibly modify the Detroit City Charter and various of its collective bargaining agreements; (2) disenfranchise the citizens of Detroit and members of the Detroit retirement systems by removing or replacing duly elected trustees without justification; and (3) potentially dissolving Detroit's retirement systems and transferring their assets and control to another retirement system. The suit asks the court to declare related portions of the Act unconstitutional and to block them from taking effect.

The complaint makes a number of broad assertions, including that the Act provides the Governor and State Treasurer with "unbridled power to declare a 'fiscal emergency' wherever and whenever they see fit" and gives emergency managers "czar-like powers ... much broader than those possessed by the local government's duly-elected leaders." However, the complaint focuses more specifically on Section 19(1)(m), related to the emergency manager's ability to remove or replace pension board trustees, serve as the pension board's sole trustee, and dissolve the plan and transfer assets to another retirement system. The complaint challenges the constitutionality of these provisions on the grounds they violate:

⁴ Citizens Research Council of Michigan, *The Local Government and School District Fiscal Accountability Act*, Report 368, April 2011, page 12.

⁵ CRC, April 2011, page 13.

- **The Contracts Clause of the U.S. and Michigan Constitutions:** The contracts clause prohibits states from passing laws that impair contractual obligations. The complaint argues that the Act violates these provisions by significantly impairing collective bargaining agreements, as well allowing the transfer of retirement system assets and control to another retirement system.
- **The Home Rule Provisions of the Michigan Constitution and Home Rule Act:** The home rule provision gives electors of each city the power and authority to frame, adopt, and amend its charter. The Home Rule Act gives cities the authority to create and maintain retirement systems and their respective boards. The complaint argues that the Act violates these provisions by amending the Detroit City Charter without the consent of its citizens, and by usurping the City's power and authority to create and administer its pension systems.
- **The Takings Clause of the U.S. and Michigan Constitutions:** The takings clause prohibits states from taking private property without just compensation. The complaint argues that the members of Detroit's retirement systems have vested rights in their pension benefits, and that allowing the transfer of retirement system assets and control to another system would adversely affect plan members, leading to a taking without just compensation.
- **The Due Process Clause of the U.S. and Michigan Constitutions:** The due process clause prohibits states from depriving any person of life, liberty, or property without due process of law. The complaint argues that the Act violates due process by granting powers over retirement systems to emergency managers that have no rational relationship to the stated purpose of the Act. Moreover, it argues the Act is impermissibly vague in creating and delegating the broad powers to the Governor, State Treasurer, and emergency manager.
- **The Equal Protection Clause of the U.S. and Michigan Constitutions:** The equal protections clause prohibits states from denying any person equal protection of the laws. The complaint argues the Act creates a classification between: (1) retirement systems that are subject to potential takeover by an emergency manager and (2) those that are not. Moreover, the classification is arbitrary and not rationally related to a legitimate government interest, thereby violating the equal protection clause.
- **The Accrued Financial Benefits Provision of the Michigan Constitution.** This provides that the accrued financial benefits of each state and local pension plan are a contractual obligation and not subject to diminishment or impairment. The complaint argues that the Act improperly impairs the benefits by allowing the transfer of administration to the emergency manager or to another retirement system, potentially resulting in the modification or elimination of the benefits.

Conclusion

The Local Government and School District Fiscal Accountability Act is intended to expand the powers of state officials and emergency managers in order to respond to financial emergencies. However, the broad powers given by the Act are being criticized on legal and constitutional grounds. As stated in the CRC's report, "While these powers provide for a more robust response to fiscal difficulties, the expanded powers come at the expense of local democracy and the ability of public sector unions to collectively bargain with government officials."