



Memorandum

TO: City Council

FROM: Mayor Chuck Reed

SUBJECT: **DECLARATION OF FISCAL
EMERGENCY**

DATE: 5/24/2011

APPROVED:

Chuck Reed DATE: 5/19/11

MEMO TO COUNCILMEMBERS

Attached is a copy of *The Law Journal* article referred to in the memo dated 5/13/10
“Declarations of Fiscal Emergency: A Resurging Option for Public Entities Attempting to Deal
With The current Economic Climate.”

I understand the electronic version may be difficult to access on the State Bar website.

Declarations of Fiscal Emergency: A Resurging Option for Public Entities Attempting to Deal With The Current Economic Climate

By Jonathon V. Holtzman, K. Scott Dickey, and Steve Cikes*

In 1978, California voters enacted Proposition 13,¹ which placed significant limitations on the taxing power of local and state governments. In response, a number of California public entities attempted to declare a state of fiscal emergency as a means of reducing costs under existing labor contracts. These efforts were universally rebuffed by the courts, in part, because the state augmented local revenues in the wake of Proposition 13. Since then, conventional wisdom has been that declarations of fiscal emergency do not work.

With the recent sharp downturn in the economy, the conventional wisdom may no longer be correct. Several cities in California are currently engaged in or contemplating efforts to control costs through emergency declarations. Although the question whether such declarations will be effective this time around rests with the courts (and in some instances with arbitrators), there is cause to believe that the unprecedented nature of the economic problems public agencies currently face could yield a different result. A declaration of fiscal emergency may prove to be a critical tool in maintaining public service levels, limiting or eliminating the need for layoffs, and avoiding municipal insolvency through bankruptcy.

WHY A DECLARATION OF FISCAL EMERGENCY MAY HELP STRUGGLING PUBLIC ENTITIES

The lion's share of most public entities' budgets – sometimes as much as 75 to 80 percent – goes to fund employee wages and salaries. The skyrocketing costs of employee benefits and unfunded labor agreements further exacerbate the budget imbalances towards labor costs. And most of these labor costs are locked in place by collective bargaining agreements that can be extremely difficult to alter, much less unwind. Consequently, most public entities only have control over a small amount of their annual costs. The elimination of 20 to 25 percent of the annual total budget – even if it were possible to do so and continue to provide services – would do little to aid an agency sliding towards insolvency.

A declaration of fiscal emergency may help unlock these otherwise fixed labor costs. Although both the United States and California Constitutions prohibit government from enacting legislation that impairs contracts,² courts have long recognized that this prohibition is subservient to government's power "to protect the lives, health, morals, comfort and general welfare of the public" – i.e., a public agency's inherent police powers.³ For example, in the

seminal case of *Home Building and Loan Association v. Blaisdell*,⁴ the United States Supreme Court upheld the constitutionality of a Minnesota law that restricted foreclosures on mortgages during the Great Depression. In doing so, the Court recognized that certain conditions may arise "in which a temporary restraint of enforcement [of contractual obligations] may be consistent with the spirit and purpose of the [Contract Clause] and thus be found to be within the range of reserved power to the state to protect the vital interests of the community."⁵ And in *Veix v. Sixth Ward Building and Loan Association*,⁶ the U.S. Supreme Court recognized that under the Contract Clause, a state's authority to protect its citizens through statutory enactments affecting contract rights "is not limited to" situations in which the public's "health, morals and safety" are at risk, but "extends to economic needs as well."⁷

Based on these precedents, a number of public entities have attempted to address instances of financial hardship by enacting legislation impairing and/or modifying their own labor agreements. The ability to suspend the provisions of labor agreements during the pendency of a fiscal emergency may, in an appropriate case, allow public entities to dynam-

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cally respond to lost or severely reduced revenues, by allowing public entities to "roll back" wages and benefits, thus reducing the impact of those losses without necessarily reducing services or staffing, and without facing insolvency. It is important to emphasize, however, that the law in this area is not well developed, and not every failing agency is failing because of an actual fiscal emergency.

THE PREREQUISITES FOR A DECLARATION OF FISCAL EMERGENCY

In *Sonoma County Organization of Public Employees v. County of Sonoma*,⁸ the California Supreme Court, following *Blaisdell*, identified four factors for courts to use in determining whether a legislative impairment of a contract will be upheld in the face of a Contract Clause challenge. First, the contract modification must arise out of an actual emergency. Second, relief from the contract must be necessary to protect a basic societal interest rather than for the benefit of a particular group of individuals. Third, the modification or relief must be appropriately tailored to the emergency it was designed to address, and the conditions that result must be reasonable. And finally, the modification imposed must be temporary and limited to the exigency that prompted the legislative response.

These factors are not necessarily absolute. Since *Blaisdell*, the U.S. Supreme Court has in some cases upheld contractual impairments without some of these factors.⁹ In *United States Trust Company of New York v. New Jersey*,¹⁰ the United States Supreme Court acknowledged this shift and stated that while "the existence of an emergency and the limited duration of a relief measure are factors to be assessed in determining the reasonableness of an impairment, ... they cannot be regarded as essential in every case."¹¹ The Court established a new standard to evaluate whether a contract impairment is constitutional, holding that "an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose."¹²

Generally, a public entity's finding of an emergency necessitating the impairment of contracts will be afforded some deference. Needless to say, however, courts will be less deferential to the decision when it considers a public entity's impairment of its own contractual obligations.¹³ As one recent court decision explained, for an impairment to be considered reasonable and necessary in such cases, the public entity must show that it did not "(1) 'consider impairing the ... contracts on par with other policy alternatives' or (2) 'impose a drastic impairment when an evident and more moderate course would serve its purpose equally well,' nor (3) act unreasonably 'in light of the surrounding circumstances.'"¹⁴

What Constitutes a True Fiscal Emergency?

One of the challenges faced by public entities in declaring a fiscal emergency is that there is no brightline rule for determining when circumstances justify such a declaration. While certainly a fiscal

emergency may exist before the public entity files for bankruptcy or reaches insolvency, courts considering whether a public entity faces an actual emergency have varied considerably in their assessments.

Several courts have found that a sharp decline in revenues and the concurrent inability to provide essential services constitutes a fiscal emergency sufficient to allow a public entity to impair its own contractual obligations. For example, in *Subway Surface Supervisors v. N.Y.C. Transit Authority*,¹⁵ the New York court of appeals upheld deferral of a wage increase set forth in the city's collective bargaining agreement, where the city's fiscal emergency would have rendered it unable to "provide essential services to its inhabitants or meet its obligations to the holders of outstanding securities,"¹⁶ and without cuts, it would not have been able to pay employee salaries or its vendors and would have defaulted on payments due on other outstanding obligations.

Similarly, in *Baltimore Teachers Union v. Mayor and City of Baltimore*,¹⁷ the court found that salary reductions imposed by the city on police and teachers were reasonable in light of a sharp decline in city revenues, including a significant reduction in state funding. Also, in *Buffalo Teachers Federation v. Tobe*,¹⁸ the court held that the city acted lawfully in imposing a wage freeze on employees after forecasting an increase in its budget deficit from \$7.5 million in fiscal year 2002-03 to \$93-127 million in 2006-07 and after the city had already laid off 800 teachers and 250 assistant teachers in the preceding four years.

In contrast, courts rejecting a declaration of emergency have tended to do so on the grounds that emergency is not a "true" emergency and that a public agency has failed to fully explore other, less intrusive cost saving measures. For instance, in *Sonoma County Organization of Public Employees v. County of Sonoma*, *supra*, the California Supreme Court found that a 6 percent reduction in revenues adopted in the wake of Proposition 13 was insufficient to justify impairment of a county's contractual obligation under its labor agreement with a union, given that the county's actions were based on a projected 22 percent reduction in revenue¹⁹ and the "Legislature almost immediately returned \$5 billion accumulated in the state's surplus to local agencies to alleviate the potential – but not realized – effects of Proposition 13."²⁰

The Second Circuit reached a similar conclusion in *Condell v. Bress*,²¹ striking down a five-day payroll lag for state employees adopted to address a budget deficit, estimated to be \$1.005 billion. The court reasoned that the legislature had done nothing to address the claimed emergency before it sought to "impair[] contract rights to obtain forced loans to the State from its employees" and, without exploring alternatives first, the state could not legitimately claim a financial emergency existed.²²

Likewise, in *University of Hawaii Professional Assembly v. Cayetano*,²³ the Ninth Circuit invalidated a state "pay lag" law, enacted to address an estimated budget shortfall of \$143 million. The court found that other, less-intrusive options were available, including a project to obtain additional funding from the federal government, further budget restrictions, and

the raising of taxes. Further, the court pointed out that "Defendants knew of the budgetary crisis at the time the collective bargaining agreement was negotiated and as the history of [the pay lag statute] shows, previously had attempted to implement a similar pay lag plan."²⁴ This authority might suggest that a true fiscal emergency must arise out of some unforeseeable chain of events occurring well after the underlying contracts were negotiated and entered into. But we believe that too much has been made of this argument.

Not all emergencies occur in an instant, like an earthquake. The current decline in municipal revenues, accompanied by the dramatic escalation in benefit costs is not something even public finance gurus anticipated. Many jurisdictions made labor agreements 'on the way down,' anticipating that the current recession would be like others seen before. Consequently, most negotiated agreements pushed wage increases off into later years – not appreciating the full extent of the collapse of the housing market and the continuing impacts it would have on revenues, or that the decline in the market would lead to the doubling of pension costs. In short, the determination that a concessionary agreement was not 'concessionary enough' in the end does not mean the public agency could or should have anticipated the severity of the problem when it entered into that agreement.

STOCKTON: A CASE STUDY

An excellent example of these principles in action is the current fiscal emergency in the City of Stockton. The Great Recession that began in the fall of 2008 had a particularly devastating impact on the economic resources of Stockton. Since the start of the Great Recession, the city saw the largest sources of revenue for its general fund – property taxes, sales and use taxes, and utility user taxes – decline precipitously, in some cases by 25 percent or more. The housing market collapse led to a 66 percent decline in median home sale prices, as well as a huge wave of foreclosures. Unemployment, meanwhile, has nearly doubled.

While revenues declined, the city faced dramatically increasing employment costs. Wages continued to increase, driven primarily because of formula-driven raises and other automatic inflators contained in the city's 'closed' labor agreements. Pension and healthcare costs also rose – and continue to rise – at alarming rates.

Because of the decrease in revenues and the persistently increasing employment costs, the city faces a \$23 million budget shortfall for fiscal year 2010-11. The estimated budget shortfall is projected to widen to \$27.3 million in fiscal year 2011-12.

The city had already implemented a variety of cost reduction measures. It had reduced city-wide staff (including police) by 23 percent, renegotiated several labor agreements, imposed furlough days, instituted a hiring freeze, and reduced city operation hours across many departments. It also had eliminated many community programs and services.

But this was not enough. Because nearly 80 percent of the city's general fund budget is attributable to police and fire costs, concessions from these unions were necessary for the city to close its budget gaps. Despite significant efforts to do so, the city was unable to reach agreement with the police and fire unions on concessions. On June 22, 2010 – after weeks of continued negotiations with the police and fire unions, and just over one week before the city was required to approve a balanced budget – the city council adopted resolutions giving the city manager the authority to impose temporary measures on police and fire bargaining units in an effort to reduce costs and close the city's budget gap.²⁵

Using its emergency powers, the city froze formula-driven raises for police and fire unions and took one fire truck out of service. The unions have sued,²⁶ and have sought arbitration under their labor agreements. While the litigation is far from over, and no one would be presumptuous enough to predict the outcome, Stockton's circumstances involve many aspects of what, presumably, should constitute a true fiscal emergency. Based on its history of cost-cutting, the city had few alternatives, and the few it had – primarily cutting additional police officers – were unquestionably dangerous to the public health, safety and welfare. Stockton attempted to work with the unions and to find alternatives, but the unions would only agree to alternatives if the city agreed to extend the untenable labor agreements even further into the future. The city had even attempted to raise revenues, but lost at the polls.

In the fire arbitration, the lead case in Stockton, the firefighters have argued that the city could have raided the workers' compensation fund and other special funds, sold property, eliminated its two assistant city managers, and taken similar short-term steps that, it asserts, might have gotten it through the 2010-11 fiscal year. While the city has argued that, at best, these would have only delayed the inevitable, the union's financial expert has countered: "Frankly, kicking a can down the road is a perfectly acceptable practice in public sector budgeting." It is precisely this kind of myopic thinking that helped develop this problem in the first place.

OPTIONS FOR AVOIDING FISCAL EMERGENCIES BEFORE THEY HAPPEN

The effects of the Great Recession will linger for most California cities and counties, and the cost of employee and retiree benefits will soar. Plainly, some jurisdictions will face insolvency. But the question remains whether, for some, declaring a fiscal emergency is a reasonable last resort before bankruptcy. Many other states have specific provisions for dealing with local fiscal emergencies. Most, however, turn local control over to the state. That hardly seems like a good or workable solution for California jurisdictions, where the state's fiscal management makes even the worst-run local governments look like pillars of financial rectitude.

Another alternative is to address the possibility of uncertain financial futures in the collective bargaining agreements themselves. For instance, public

agencies could attempt to negotiate provisions that preclude increases in salaries where the funds have not been certified as available in the budget or by supplemental appropriation. Provisions allowing temporary suspension of cost-of-living adjustments, or requiring temporary increases in employee participation in funding health and pension benefits – or at the very least, permitting a more streamlined process for negotiating such temporary changes with the unions – may prove to be a viable option for some agencies. Public agencies also may wish to coordinate their agreements so that they come up for renewal at the same time, thus avoiding additional – and unforeseeable – future financial problems.

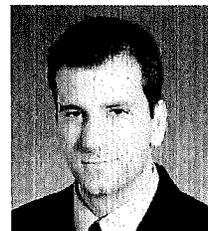
In the meantime, stay tuned. A lot of law on fiscal emergencies is likely to get made in the next few years.



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Endnotes

- 1 Incorporated into the California Constitution as Article 13A. See http://www.leginfo.ca.gov/.const/.article_13A.
- 2 Article I, section 10 of the United States Constitution, known as the "Contract Clause," states that "[n]o State shall ... pass any ... [l]aw impairing the Obligation of Contracts." Article I, section 9 of the California Constitution similarly provides that a "law impairing the obligations of contracts may not be passed."
- 3 *Manigault v. Springs*, 199 U.S. 473, 480 (1905); see also *Hudson Water Co. v.*

- 4 *McCarter*, 209 U.S. 349, 357 (1908) (Justice Holmes, writing for the Court, stated: "One whose rights, such as they are, are subject to state restriction, cannot remove them from the power of the State by making a contract about them. The contract will carry with it the infirmity of the subject matter.")
- 5 290 U.S. 473 (1937).
- 6 *Id.* at 439.
- 7 310 U.S. 32 (1940).
- 8 *Id.* at 38-39.
- 9 23 Cal. 3d 296 (1979).
- 10 See *Veix, supra*, 310 U.S. at 39-40 (recognizing that an emergency need not be declared and relief measures need not be temporary for an impairment to be deemed constitutional).
- 11 431 U.S. 1 (1977).
- 12 *Id.* at 23 n.19.
- 13 *Id.* at 25.
- 14 See *University of Hawaii Professional Assembly v. Cayetano*, 183 F.3d 1096, 1106 (9th Cir. 1999) (quoting *Condell v. Bress*, 983 F.2d 415, 418 (2d Cir. 1993) ("Courts are less deferential to a state's judgment of reasonableness and necessity when a state's legislation is self-serving and impairs the obligations of its own contracts.") (emphasis in original)).
- 15 *Buffalo Teachers Federation v. Tobe*, 464 F.3d 362, 371 (2d Cir. 2006) (quoting *United States Trust Co. of New Jersey*, 431 U.S. at 30-31).
- 16 44 N.Y.2d 101 (1978).
- 17 *Id.* at 111 n.3.
- 18 6 F.3d 1012 (4th Cir. 1993).
- 19 464 F.3d 362 (2d Cir. 2006).
- 20 23 Cal. 3d at 310-312.
- 21 *Id.*
- 22 983 F.2d 415 (2d Cir. 1993).
- 23 *Id.* at 419-420.
- 24 183 F.3d 1096 (9th Cir. 1999).
- 25 *Id.* at 1107.
- 26 See the staff reports at <http://www.stocktongov.com/clerk/granicusagendas/citycouncil/20100622.pdf>.
- 27 See *Stockton Firefighters' Local 456, Intl. Assn. of Firefighters v. City of Stockton*, San Joaquin County Superior Court Case No. 39-2010-00244326 CU-PT-STK; *Stockton Police Officers' Assn. v. City of Stockton*, San Joaquin County Superior Court Case No. 39-2010-00245197 CU-WM-STK.