

# California Enacts Controversial Municipal Bankruptcy Law: Assembly Bill 506

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A years-long political duel over whether California should control local government bankruptcies was resolved on October 9, 2011. Chapter 9 of the Bankruptcy Code provides specifically for the reorganization of cities and towns, taxing districts, municipal utilities, and school districts. California Governor Jerry Brown (D) signed legislation prohibiting local municipalities from filing for bankruptcy unless they first negotiate with creditors using a “neutral evaluation process” or vote to declare a fiscal emergency after a public hearing. Prior versions of the legislation would have required permission from a state agency before bankruptcy could be declared.

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## Bill Touted as Offering “Less Drastic” Solution to Bankruptcy

Assembly member Bob Wieckowski (D-Fremont), who sponsored the bill, said in a statement that the bill represents “a positive and reasonable step to forge an agreement on debt restructuring by municipalities in distress without going into bankruptcy.” Wieckowski proposed the measure with support from the California Labor Federation and other union groups whose labor contracts could be jeopardized by local government bankruptcies.

Prior California law allowed local government agencies to file for bankruptcy without state approval or preconditions. Doing so is rare, however. In California, only two cities and one county have resorted to bankruptcy since 1949. However, most states prohibit local governments from filing for bankruptcy, and the dozen or so that do not put significant restrictions well beyond those outlined in AB 506.

In a statement, Brown said the bill offers alternative, “less drastic solutions” to bankruptcy.

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## Political Considerations, Economic Factors Led to Legislation

AB 506 was introduced in response to complaints from public sector unions regarding the City of Vallejo’s bankruptcy filing in 2008 and the perception that other cities and towns may also file



for bankruptcy due to the on-going fiscal crisis stemming from the recession. Vallejo, the largest city every to declare bankruptcy in California, was forced to file for Chapter 9 protections in part because it could no longer afford the contracts it signed with its employees due to declining tax revenues. Although the unions representing Vallejo's public employees believed their contracts would not be altered in bankruptcy, the federal judge overseeing the case ruled that the city could substantially reduce benefits such as health care and pension payments. This has caused considerable consternation among California's public sector unions, which in response pressed for legislation that would prevent cities and other municipalities from declaring bankruptcy without any oversight and have strongly supported AB 506.

Many municipal governments, not wanting to lose authority over the bankruptcy process, were opposed to the idea of the State's invention in what they consider a local governance issue, and as a result came out against earlier versions of the bill. However, the California League of Cities issued a statement supporting the final legislation after Assemblyman Wieckowski agreed to drop the provision requiring local governments get permission from the State prior to filing for bankruptcy in federal court. Still, the bill represents a major change from previous law and places unprecedented requirements on local officials. In light of this, approximately a third of the legislature (46-21 in the Assembly and 28-10 in the Senate) voted against it even though it was considered a compromise and is less restrictive than the laws of most other States.

For further information regarding this legislation, please contact the Arent Fox attorney with whom you regularly work or one of the individuals listed below.

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