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Senate Bill 175 (Substitute S-1 as passed by the Senate)  
Sponsor: Senator Dan L. DeGrow  
Committee: Education and Mental Health

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**RATIONALE**

In 1988, the Legislature enacted the Local Government Fiscal Responsibility Act to accelerate the State's identification of local units of governments experiencing financial distress, and enable the State to impose various remedial measures corresponding to the severity of the problem. Many people now believe that a similar measure should be approved to deal with financially troubled school districts. That suggestion was among the recommendations of the Select Panel on the Detroit Public Schools appointed in June 1988. According to the Select Panel's report of December 14, 1988, the Detroit Public School (DPS) District has experienced a deficit general fund balance in 11 of the past 15 fiscal years, beginning July 1, 1972. Reportedly, applying generally accepted accounting principles, the deficit was \$82.9 million for the fiscal year ending June 30, 1987, and \$101.6 million for the following fiscal year. It is estimated that for the fiscal year ending June 30, 1989, the DPS deficit will total \$151-\$152 million. (For more information about the DPS District, see BACKGROUND.)

Although the DPS has the largest and most widely publicized deficit, by no means is it the only school district having financial problems. A Department of Education (DOE) report indicates that a total of 28 school districts, including one intermediate school district, had a deficit for the fiscal year ending June 30, 1989. According to testimony of the State Superintendent of Public Instruction, while the DPS took 11 years to accumulate a deficit amounting to about 19% of the district's

operating expenses, another district went into a 19% deficit in just one year.

Measures to deal with deficit school districts do exist but are considered inadequate. These measures include a series of administrative steps that require a district to submit a plan to eliminate its deficit by the end of the second fiscal year after the year the deficit was incurred. Also, the DOE reportedly is developing an early warning system to identify financially troubled districts and ward off serious problems. Ultimately, however, the only action the State Superintendent can take against districts that fail to balance their budget is to reduce or withhold their State school aid payments: less drastic, intermediary remedies are not available. Further, although districts can eliminate a deficit if their electors approve millage increases or bond issues, many people agree that relying on a succession of deficit elimination bond issues amounts to poor fiscal and public policy.

For these reasons, it has been suggested that procedures patterned after those in the Local Government Fiscal Responsibility Act be instituted for school districts, to detect financial problems before they become serious and to manage the problems when they do become serious.

**CONTENT**

The bill would repeal the Local Government Fiscal Responsibility Act and

re-enact it under the same name, containing virtually identical language for local units of government but adding similar provisions for school districts. The new provisions for school districts would do the following:

- Authorize the Superintendent of Public Instruction to determine whether a school district had a "serious financial problem" if certain conditions existed.
- Require the Governor to appoint a review team to review a school district's financial condition if the Superintendent determined that the district had a serious financial problem or if other occurrences took place.
- Require the Governor to determine that a district had a financial emergency if the district had a serious financial problem and a consent agreement to resolve the problem had not been adopted; provide for a hearing with the school board to contest the determination; and, permit an appeal to the circuit court.
- Require the Governor to appoint, from nominees submitted by the State Board of Education and with the advice and consent of the Senate, an emergency financial manager for a school district that had a financial emergency.
- Require the manager to assume control over the district's financial matters and develop a financial plan for the district.
- Authorize the manager to take other actions such as recommending that the district be reorganized with other districts, ordering school millage elections, and filing for bankruptcy.
- Provide that a manager would receive compensation and reimbursement from the school district, and that amount would be deducted from the district's State Aid payments.

The bill also provides that a review team and an emergency financial manager appointed for

a local unit under the current Act and serving on the bill's effective date would continue to fulfill their powers and duties. In addition, the bill would require the emergency financial manager to make public his or her financial plan for the local government, but would not require public approval of the plan.

The new provisions for school districts are described in more detail below.

#### Serious Financial Problem

The Superintendent of Public Instruction would be responsible for monitoring and periodically reviewing the financial condition of school districts to ensure their compliance with State laws regulating budgetary and accounting practices and their financial soundness. The Superintendent could determine that a school district had a serious financial problem if he or she found that one or more of the following conditions existed:

- The school district ended the most recently completed school fiscal year with a deficit in at least one of its funds and the Superintendent of Public Instruction had not approved a deficit elimination plan within three months after the district's deadline for submitting its annual financial statement.
- The school board adopted a resolution declaring that the district was in a financial emergency.
- The Superintendent received a petition containing specific allegations of school district financial distress signed by a number of registered electors residing within the school district, or nonregistered electors residing within a nonregistration school district, equal to at least 10% of the total vote cast for all gubernatorial candidates within the district at the last election at which a governor was elected. Petitions could not be filed within 60 days before any election in the district.
- The Superintendent received a written request, from a creditor of the school district with an undisputed claim against the district, to find the district had a serious financial problem. The Superintendent could honor this request only if the claim were at least six

months overdue, the claim exceeded \$10,000 or 1% of the district's annual general fund budget, whichever was larger, and the creditor notified the district at least 30 days before he or she made the request to the Superintendent.

- The Superintendent received written notice from a trustee, paying agent, note- or bond-holder, or the State Treasurer of a violation of one or more of the district's bond or note covenants.
- The Superintendent received a resolution from the Senate or the House of Representatives requesting a review of the district's financial condition.
- The district was in violation of the conditions of an order issued under, or as a requirement of, the Municipal Finance Act or any other law governing the issuance of bonds or notes.
- The district was in violation of requirements of the Uniform Budgeting and Accounting Act pertaining to deviations from a general appropriations act, unauthorized creation of debt or expenditure of funds, and violations.
- The district failed to provide an annual financial report or audit that conformed with the minimum procedures and standards of the State Board of Education and was required under the School Code and the State School Aid Act.
- A court had ordered an additional tax levy without the prior approval of the school board of the district.

Upon determining that a school district had a serious financial problem, the Superintendent would have to notify the Governor and the State Board of that determination and of the basis for the findings supporting it.

#### Review Team

Within 30 days after an occurrence described below, the Governor would be required to appoint a review team composed of the Superintendent of Public Instruction, the State Treasurer, the Director of the Department of Management and Budget, a nominee of the Senate Majority Leader, and a nominee of the Speaker of the House, to review the financial condition of a school district if any of the following occurred:

- The Governor was informed by the Superintendent that he or she had determined that a school district had a serious financial problem.
- The district was in default in the payment of interest on or principal of any of the district's obligations.
- The district failed to pay its employees within five days of any regularly scheduled payday.
- The district failed to make any contribution required by a pension, retirement, or benefit plan in accordance with State law.
- The district failed to comply with the terms of an approved deficit elimination plan required under the State School Aid Act.
- The State Treasurer notified the Governor that the appointment of a review team was necessary to protect the credit of the district or the State, or both.

The review team would have full power to examine the books and records of the district, and use the services of other State agencies and employees and employ necessary professionals. In addition, the team could sign a consent agreement with the superintendent of the district. The agreement could provide for remedial measures, including a long-range financial recovery plan requiring specific actions. The agreement could use State financial management and technical assistance as necessary to alleviate the district's financial problem, and could provide for periodic fiscal status reports to the Superintendent of Public Instruction. Before the agreement took effect, the school board, by a majority vote of its total members, would have to approve the agreement.

The review team would have to report its findings to the Governor and the State Board within 30 days after its appointment, or earlier if required by the Governor. Upon request, the Governor could grant one 60-day extension of this time limit. The team would have to send a copy of its report to the Superintendent of Public Instruction, the district's school board, the Senate Majority Leader, and the Speaker of the House. The team would have to include one of the following conclusions in its report,

and within 30 days after receiving the report the Governor would have to make one of the following determinations: a) the district did not have a serious financial problem; b) the district did have a serious financial problem, but a consent agreement containing a plan to resolve the problem had been adopted; or c) the district had a financial emergency because a consent agreement had not been adopted.

#### Financial Emergency

Upon determining that a financial emergency existed because a consent agreement had not been adopted, the Governor would have to give the board of the school district written notice of that determination, findings of fact used as the basis for the determination, a concise and explicit statement of the underlying facts supporting the findings of fact, and notice that the board had 10 days to request a hearing conducted by the Governor or his or her designee to contest the determination. After the hearing, or if no hearing were requested, after the deadline for requesting a hearing had passed, the Governor would have to confirm or revoke the determination. If the determination were confirmed, the Governor would have to give the board a written report of findings of fact of the continuing or newly developed conditions or events that provided the basis for the confirmation, and a concise and explicit statement of the underlying facts supporting these findings.

If, at any time after the Governor determined that a financial problem existed but a consent agreement had been adopted, the Superintendent of Public Instruction informed the Governor and the State Board that the school district was not abiding by the consent agreement, the Governor would have to determine that the district had a financial emergency.

A school district could appeal the determination of a financial emergency in the Ingham County Circuit Court or the circuit court for the county in which the district was located. The court could not set aside a determination unless it found that the determination was either a) not supported by competent, material, and substantial evidence on the whole record, or b) arbitrary, capricious, or clearly an abuse or unwarranted exercise of discretion.

After receiving a recommendation from the emergency financial manager, the Governor could determine and certify that the conditions for revoking the declaration of a financial emergency had been met. The manager could condition the recommendation upon the school board's adoption of a resolution that would ensure the adoption of a balanced budget, elimination of any remaining accumulated deficit, and prevention of additional negative fund balances.

#### Appointment of Emergency Financial Manager

If the Governor determined that a school district had a financial emergency, the Governor would have to request that the State Board submit to him or her within 30 days the names of three nominees to serve as an emergency financial manager for the district. From among the names, the Governor would have to appoint, with the advice and consent of the Senate, an emergency financial manager, who would serve at the pleasure of the Governor.

An emergency financial manager would have to be chosen solely on the basis of his or her competence in fiscal matters. The manager could not have been either an elected or appointed official or an employee of the district for at least five years before the appointment; could not be the Superintendent of Public Instruction; and would not have to be a resident of the district.

An emergency financial manager would receive compensation and reimbursement for expenses from the school district. The Department of Education would have to deduct the amount of the compensation and reimbursement from State Aid payments to the district. In addition to staff otherwise authorized by law, with the approval of the State Superintendent, the manager could appoint additional staff and secure professional assistance considered necessary.

The emergency financial manager would be required to issue to the appropriate officials or employees of the district the orders he or she considered necessary to accomplish the purposes of the bill, including orders for the timely and satisfactory implementation of a financial plan.

An order would be binding on the district officials or employees.

### Financial Plan

In consultation with the school board, the emergency financial manager would have to develop, and from time to time could amend, a written financial plan for the district. The plan would have to provide for both of the following:

- Conducting the operations of the district within the resources available according to the manager's revenue estimate.
- Paying in full the scheduled debt service requirements on all bonds and notes of the district and all other uncontested legal obligations.

After initially developing the plan, the manager in consultation with the school board would be required regularly to re-examine the plan. If the manager reduced his or her revenue estimates, the manager would have to modify the plan accordingly.

The plan would have to be in a form, and contain the information for each year the plan was in effect, that the district's emergency financial manager specified. The manager would have to make the plan or modified plan public, but would not have to receive public approval before implementing the plan or modification.

### Emergency Financial Manager Authority

Immediately upon his or her appointment, an emergency financial manager would have to assume control over all fiscal matters of, and make all fiscal decisions for, the district. A manager could do all of the following:

- Examine the books and records of the district.
- Review payrolls or other claims against the district before payment.
- Negotiate, renegotiate, approve, and enter into contracts on behalf of the district.
- Receive and disburse on the district's behalf all Federal, State, and local funds earmarked for the district, including funds for specific programs and debt retirement.

- Adopt a final budget for the next school fiscal year and amend any adopted budget.
- Act as an agent of the district in collective bargaining and, to the extent possible under State labor law, renegotiate existing and negotiate new labor agreements.
- Analyze factors contributing to the district's financial condition and recommend to the Legislature steps necessary to improve it.
- Require compliance with his or her orders, by court action if necessary.
- Require the attendance of witnesses and the production of documents relevant to an analysis of the district's financial condition.
- Recommend to the Governor, the Legislature, and the State Board of Education that the district be reorganized with one or more contiguous districts.
- Consolidate divisions or transfer functions from one division to another within the district and appoint, supervise, and, at his or her discretion, remove heads of divisions of the district.
- Create a new position or approve or disapprove the creation of any new position or the filling of any vacancy in a permanent position by any appointing authority.
- Seek approval from the State Board for a reduced class schedule in accordance with administrative rules governing the distribution of State school aid.
- Employ or contract for, at the district's expense and with the approval of the Superintendent of Public Instruction, auditors and other technical personnel considered necessary to implement the Act.
- Reduce expenditures in the district's budget.
- Borrow money on behalf of the district.
- Approve or disapprove the issuance of obligations of the district.
- Order one or more school millage elections for the district.
- Sell or otherwise use the assets of the district to meet past or current obligations, provided this use did not impair education in the district.
- Exercise the authority and

responsibilities affecting the district's financial condition that were prescribed by law to the school board and the district superintendent.

- File for bankruptcy under Chapter 9 of Title 11 of the United States Code (which applies to municipal debts).

The Superintendent of Public Instruction, the Department of Education, and the school board, employees, and administrators of the district that had a financial emergency would have to provide the assistance and information considered necessary and properly requested by the emergency financial manager in effectuating his or her powers and duties under the Act. The school board would have to comply with orders issued by the manager and could take actions necessary to comply with the Act or as prescribed by the review team, the State Superintendent, or the emergency financial manager in implementing the Act.

The State, the Superintendent of Public Instruction, and an emergency financial manager would not be liable for any obligation of or claim against a school district resulting from actions taken according to the Act.

## **BACKGROUND**

In June 1988, upon the suggestion of the State Board of Education, the Interim State Superintendent of Public Instruction appointed a five-member panel to investigate matters relating to the Detroit Public School District's deficit and to formulate recommendations for improved performance. The Select Panel was charged with answering four questions: How large is the deficit? How can the deficit be eliminated? How can future deficit spending be prevented? What are the implications of the deficit on the quality of educational programs and student performance?

In its December 14, 1988, report, the Select Panel made the following major recommendations, which were endorsed by the State Board in January 1989:

1. The DPS District should adopt specific, measurable quality education goals and should allocate its available resources to achieve those goals.
2. The State Superintendent of Public

Instruction should annually report to the public regarding the progress of the District toward achieving the quality education goals.

3. The State Board of Education should revise the Michigan School Accounting Manual to conform with generally accepted accounting principles. (Reportedly, a revised manual has been adopted.)
4. The DPS and the State should jointly fund an Operations Improvement and Restructuring project to reduce annual operating costs by \$50 million, prioritize the allocation of resources, improve the financial management of the District, and provide training in financial decision-making to key managers and school board members.
5. The State Board should identify the incremental costs of a first class school district and recommend State funding of these costs. Any increase in State Aid for incremental costs should be tied directly to implementation of the recommendations of the Operations Improvement and Restructuring project.
6. The DPS board should develop by January 1, 1989, a balanced budget for fiscal year 1989-90 following the timeline and procedures outlined by the Select Panel's draft legislation. The State Superintendent should determine by March 1, 1989, whether the proposed budget was in balance.
7. The Legislature should adopt legislation to revise the DPS District budget process and budgeting cycle to assure balanced budgets.
8. The Legislature should adopt legislation to create a public school emergency financial director who will function as an external oversight mechanism to ensure financial accountability in the DPS District.
9. Voters of the DPS District should approve an operating millage increase and a deficit elimination bond issue.

The DPS District did place on the November 8, 1988, general election ballot two propositions: a six-mill property tax increase, and a \$160 million deficit elimination bond issue. Both proposals were defeated. On September 12, 1989, DPS electors will vote on a proposal that

would levy five mills for operations and 1.5 mills for deficit reduction bonds.

Earlier this year, the Municipal Finance Authority purchased notes from the DPS District enhanced by a bank letter of credit, with the understanding that the District would submit an amended deficit elimination plan by June 1. The deadline was extended to July 7, when the District did submit a plan that was rejected by the State Superintendent. Reportedly, for the present, a revised plan is not being required, and school aid cuts are not being imposed.

### **FISCAL IMPACT**

There would be no new costs from Articles 1 and 2 of the bill as these articles would reenact existing law. Article 3 of this bill would result in costs to the State of about \$400,000 within three years. The costs would be reimbursement for State-mandated costs for the appointment of emergency financial managers in financially distressed school districts. This estimate is based upon a report prepared by the Department of Education of those school districts experiencing financial difficulty for the fiscal year ending June 30, 1988. The report lists 27 school districts and one intermediate school district. Of these school districts it would seem that four would be likely targets for assistance under this bill. This analysis assumes costs of \$100,000 for each appointed manager for one year (4 X \$100,000 X 1).

It is presumed that there would be cost savings to local and intermediate school districts where a manager was appointed. An appointed manager could eliminate costs of school boards and operating programs as well as implement efficiency measures. The amount to be saved would be indeterminate and based upon whatever reductions the manager determined were necessary to make the school district solvent.

### **ARGUMENTS**

#### **Supporting Argument**

Because State government has a vital role in protecting the solvency of local governments and school districts, it must have a means to detect and remedy serious financial problems at the local level. What the Local Government Fiscal Responsibility Act is doing for local units

(specifically, the City of River Rouge and Royal Oak Township, at present), the bill would do for school districts. That is, the bill would provide a forward-looking mechanism to identify financial problems before they became serious as well as a procedure to impose fiscal discipline when those problems got out of hand. The bill is based both on the local government Act and on the Select Panel's draft legislation. While the panel's draft was geared toward Detroit Public Schools, however, the bill would be broad enough and flexible enough to apply to any financially troubled district in the State. Instead of resorting to closing a school's doors or pulling the plug on State Aid payments, the bill proposes a progressive series of actions to identify and avert financial problems or remedy a financial crisis. This approach would begin with oversight by the State Superintendent to determine whether a district had a serious financial problem, and would progress to the appointment of a review team if a serious financial problem were found or if other triggering factors occurred. At this point, the review team and the district superintendent could enter into a consent agreement that provided for remedial measures, including a long-range financial recovery plan. As a last resort, if no consent agreement were entered into, the Governor would declare a financial emergency and appoint an emergency financial manager who would assume control over all fiscal matters of the district. This series of steps would tailor the State's response to the severity of financial problems in a particular district.

#### **Supporting Argument**

The State and school districts owe it to the schoolchildren of Michigan to ensure the solvency of their schools. As the Select Panel report points out, "[T]here is a link between financial performance and measures of quality and student performance... [C]ontinued operating deficits can only hamper efforts to achieve quality education, since deficits undermine the credibility of the District in the eyes of the community and draw time and energy away from efforts to improve the quality of educational programs... The Select Panel believes that the twin objectives of eliminating budget deficits and improving the quality of education in the Detroit Public Schools are compatible. Indeed, the Panel feels that long-term improvements in the quality of

education can come only in the context of sound fiscal status." What is true in Detroit is true throughout the State: educational reform cannot be achieved in an environment of educational insolvency. This bill is as necessary as other measures--such as core curriculum, school improvement plans, and annual reporting--designed to promote quality education in Michigan.

#### **Opposing Argument**

Instead of giving the Governor the power to appoint an emergency financial manager, the bill should authorize the State Board of Education to make that appointment based on recommendations of the Superintendent of Public Instruction. The Board and the Superintendent are in an optimal position to understand the scope of the problems and needs of a school district and to select a candidate with the strong financial and curriculum experience required for the position.

**Response:** Some people believe that granting the appointive power to the State Board could interfere with the Governor's constitutional authority. Further, the State Board would have considerable influence under the bill, since the Governor's appointment would have to be made from nominees submitted by the Board.

#### **Opposing Argument**

The bill should provide for the review team or the State Superintendent to appoint an emergency financial manager. Unlike the Governor or the State Board, the review team or Superintendent would be in a better position to observe the day-to-day operations of the manager. At the same time, the bill should provide for the creation of a permanent review team, rather than the appointment of a separate team for each school district in financial trouble. A permanent review team would provide continuity and would be more consistent with the law's provisions for local governments. Under those provisions, the responsibility for managing a local government financial emergency is assigned to the Local Emergency Financial Assistance Loan Board, which appoints an emergency financial manager.

#### **Opposing Argument**

Under the bill, once the Governor determined that a financial emergency existed in a district,

the Governor would essentially replace the local school board with someone analogous to a court-appointed receiver. By giving an emergency financial manager authority over literally all fiscal decisions of a district, the bill would undermine Michigan's long tradition of local control, implying that the local board was to blame for the district's financial troubles. Further, the bill is one-sided: while it would unilaterally remove the local board's decision-making authority, it would empower the financial manager to negotiate with labor unions.

**Response:** A court-appointed receiver's powers are as broad as the court wants to make them. An emergency financial manager's powers would be limited to those enumerated in the bill.

#### **Opposing Argument**

The bill proposes a scheme that would contain little opportunity for public input. Unlike publicly elected members of a local school board, an emergency financial manager would have no accountability to taxpayers, teachers, or students. While a review team presumably would be subject to the Open Meetings Act (as is a review team appointed for a local government), once the financial manager was appointed there would be no forum in which members of the public could voice their concerns or even observe the decision-making process. The inadvisability of this scenario is currently being demonstrated in the City of Ecorse, where communications have broken down between a judicially appointed receiver and the people, and Open Meetings Act protections are not available.

**Response:** Once a financial crisis has been reached, it is important for one individual to have carte blanche authority to make essential decisions without having to be constantly answerable to competing local interests. If conditions had deteriorated to the point at which an emergency financial manager was needed, it should be clear that the normal decision-making processes, together with their concomitant public forums, had failed.

#### **Opposing Argument**

Bankruptcy is not an appropriate recourse for a municipality or a school district. Unlike an insolvent corporation, the local unit or school would remain in existence after bankruptcy proceedings and, after starting out with a clean



slate, could simply go bankrupt again. Furthermore, the bill's bankruptcy provisions for school districts would be far more permissive than current bankruptcy provisions for local units. Under the law, an emergency financial manager must notify the Local Emergency Financial Assistance Loan Board of his or her authorization for the local unit to proceed with bankruptcy, and include a determination that no feasible financial plan can be adopted or implemented to resolve the financial emergency on time. The Loan Board then can disapprove the manager's authorization. These provisions make bankruptcy for a local unit a last resort. Under the bill, however, it could be the first action of a school district's emergency financial manager, who would be subject to no overriding authority.

**Response:** Bankruptcy is the ultimate enforcement mechanism, and allowing it for school districts would be consistent with current provisions for local units. Further, many other types of debtors declare bankruptcy to reorganize, rather than to liquidate.

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