CLARK HILL

MEMORANDUM

TO: Michigan Association of School Administrators

FROM: Michael J. Pattwell

DATE: September 16, 2014

CLIENT MATTER: 47623/177757

SUBJECT: *Legal Analysis of Senate Bills 951, 952, 953, 954, and 957 of 2014*

I. OVERVIEW

This memorandum analyzes Senate Bills 951, 952, 953, 954, and 957 which were introduced on May 21, 2014 (the "Senate Bill Package"). If enacted, the Senate Bill Package would amend: (i) the State School Aid Act of 1979, 1979 PA 94, MCL 388.1601 *et seq.*; (ii) the Revised School Code of 1976, 1976 PA 451, MCL 380.1 *et seq.*; and the Local Financial Stability and Choice Act, 2012 PA 436, MCL 141.1541 *et seq.*, to prescribe certain measures for, and requirements that must be met by, school districts, intermediate school districts, and/or public school academies (referred to generally as "School Districts").[1] The entire Senate Bill Package was referred to the Senate Committee on Appropriations. Senate Bills 951, 952, and 957 have been substituted in committee. Moreover, the Senate Fiscal Agency has conducted a Bill Analysis for the Senate Bill Package which is attached hereto as **Exhibit A**.

The first part of this memorandum discusses whether the Senate Bill Package violates the Headlee Amendment's prohibition against unfunded mandates. With respect to Senate Bills 951, 953, and 954, the answer is "no." Those Bills do not, on their face, mandate School Districts to perform any new activity. With respect to Senate Bills 952 and 957, however, the answer is likely "yes." These two Bills direct certain School Districts to comply with several new recordkeeping and reporting requirements which include, but are not limited to, the preparation and submittal of: (i) preplan financial reports; (ii) amended budgets; (iii) deficit elimination plans ("DEPs"); (iv) monthly monitoring reports on revenue and expenditures; (v) enhanced deficit elimination plans ("EDEPs"); (vi) enhanced monthly monitoring reports on revenue, expenditures, cash flow, debt, other liabilities, assets, budget amendments, pupil membership, and other data relating to finances; (vii) budgetary assumption reports; and/or (viii) periodic financial status reports. Indeed, Senate Bill 952 could even require School Districts who have entered into Financial Recovery Agreements to hire local auditors, inspectors, consultants, or other experts to ensure compliance with the applicable Financial Recovery Agreement.

[1] While most of the mandated requirements apply only to school districts that are financially stressed or anticipate becoming financially distressed, some of the requirements apply to all School Districts regardless of their financial condition.

As recognized by the Senate Bill Analysis, compliance with the new recordkeeping and reporting requirements imposed by Senate Bills 952 and 957 would force certain School Districts to incur additional expenses and costs in the form of paying current employees overtime, hiring new employees, and/or engaging professionals. The Bills, however, do not appropriate any additional funds to cover these increased costs. Accordingly, because the Bills do not appropriate the funds necessary for School Districts to accomplish the mandates contained therein, there exists a strong argument that, in their current form, Senate Bills 952 and 957 violate the Headlee Amendment's prohibition on unfunded mandates.

The second part of this memorandum discusses whether the Senate Bill 953 circumvents existing legal prerequisites that must be met before a State Treasurer may declare a financial emergency and recommend appointment of an emergency manager over a school district. The answer is "yes." Senate Bill 953 adds a new section 7a to the Local Financial Stability and Choice Act, that would allow the State Treasurer to unilaterally declare a School District to be in a state of financial emergency and recommend the appointment of an emergency manager if a School District (required to submit and comply with an EDEP) failed to submit an EDEP or comply with an EDEP's requirements. The Bill would therefore permit a State Treasurer to recommend the takeover of a School District by an emergency manager without satisfying the extensive, deliberate, and inclusive financial review processes (including a right to judicial review) presently mandated by sections 4-7 of the Local Financial Stability and Choice Act.

II. THE SENATE BILLS

A. Senate Bill 951 (S-3)

Senate Bill 951 (S-3) amends sections 17a and 18 of the State School Aid Act to, among other things: (i) require schools districts to adopt an annual budget in a form that complies with the Uniform Budgeting and Accounting Act ("UBAA"); (ii) allow the Michigan Department of Education ("MDE") to permanently withhold up to 10% of total state school aid if a School District does not adopt an annual budget in a form that complies with the UBAA by the end of the School District's fiscal year; and (iii) make all allocations to School Districts under the State School Aid Act contingent upon the School District's compliance with section 18 of the State School Aid Act. *Notably, the Senate Bill Analysis identified that the Uniform Budgeting and Accounting Act defines School Districts as "local units" subject to the UBAA's requirements and thus already required schools districts to adopt budgets in compliance with its requirements. The UBAA was enacted in 1978. See 1978 PA 621.*

B. Senate Bill 952 (S-1)

Senate Bill 952 (S-1) adds a new section 1220 to the Revised School Code that, among other things, requires a School District that had an existing deficit fund balance, incurred a deficit in the previous school year, or adopted a budget that projected a deficit fund balance to: (i) immediately notify the Superintendent of Public Instruction ("SPI") and the State Treasurer of same; (ii) submit a preplan financial report in the form and manner prescribed by the Department of Treasury, and submit such report to its board; (iii) submit to the SPI in the form and manner

prescribed by the MDE an amended budget for the current school fiscal year and a DEP[2] approved by the board, with a copy to the State Treasurer; (iv) upon the MDE's approval of the DEP, require the School District to post the DEP to its website; and (v) submit to the SPI and the State Treasurer a monthly monitoring report on revenue and expenditures in a form and manner prescribed by the MDE, post those reports on its website, and transmit those reports to the intermediate school district ("ISD") superintendent and authorizing body as appropriate.

Senate Bill 952 also authorizes the State Treasurer to require School Districts to prepare and submit for approval an EDEP if the State Treasurer determines that the School District is subject to rapidly declining financial circumstances, persistently declining enrollment, or other indicators of financial stress. The State Treasurer may also condition its approval of an EDEP upon the School District entering into a Financial Recovery Agreement which may provide for, *inter alia*: (i) the appointment of a local auditor or inspector or both; or (ii) the retention by the School District of a consultant or one or more other experts for the purpose of assisting the School District in achieving compliance with the Financial Recovery Agreement. Furthermore, under Senate Bill 952, a School District required to submit an EDEP must also to submit to the SPI and State Treasurer an enhanced monthly monitoring report on revenue, expenditures, cash flow, debt, other liabilities, assets, budget amendments, pupil membership, and other data relating to the finances of the entity, in a form and manner prescribed by Treasury, and post the reports on its website.

C. Senate Bill 953

Senate Bill 953 adds a new section 7a to the Local Financial Stability and Choice Act that would allow the State Treasurer, in a situation in which a School District was subject to an EDEP and failed to submit an EDEP or comply with its requirements, to unilaterally declare that a financial emergency exists within such School District and recommend that the governor appoint an emergency manager to address the financial emergency. While the state is required to pay the salary of an emergency manager under the Local Financial Stability and Choice Act, there exist several other costs and expenses related to emergency management which could accrue to a School District. *See* MCL 141.1560.

D. Senate Bill 954

Senate Bill 954 amends section 102 of the State School Aid Act to, among other things, allow the MDE to withhold some or all of the money payable to a School District that was required, but failed, to submit a DEP or EDEP, or failed to obtain approval of its DEP or EDEP.

E. Senate Bill 957 (S-3)

Senate Bill 957 (S-3) adds a new section 1219 to the Revised School Code that, among other things: (i) requires each school district to transmit by July 7 of each school year a budgetary assumption report (which must include at least the assumed foundation allowance, projected pupil membership, expenditures per pupil for the prior year, and projected expenditures

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[2] Senate Bill 952 would also allow the SPI to require a DEP to contain an academic plan.

per pupil) to the superintendent of the ISD in which the school district is located; (ii) require the ISD superintendent and authorizing body to review by July 30 each budgetary assumption report and complete and transmit to the State Treasurer and to the constituent districts an assumption summary report that included at least the name of each school district the projected foundation allowance, the projected membership, the reported expenditures per pupil, and a determination of whether the projected foundation allowance and membership were reasonable or unreasonable based on one or more of four prescribed factors; and (iii) allow the SPI or State Treasurer to require a School District to submit periodic financial status reports if either determined that *potential* financial stress existed, that a deficit could arise during the current year or the following two years, or that the School District could be unable to meet its financial obligations while also satisfying its obligations or abilities to provide public educational services based upon certain specified conditions.

III. ANALYSIS

A. Senate Bills 952 And 957 Likely Violate The Headlee Amendment's Prohibition Against Unfunded Mandates

Under Michigan's Headlee Amendment, the state may not reduce funding levels for the necessary costs of existing activities of local governments mandated by the legislature, and must completely fund the necessary costs of new or increased activities of local governments mandated by the legislature:

> The state is hereby prohibited from reducing the state financed proportion of the necessary costs of any existing activity or service required of units of Local Government by state law. A new activity or service or an increase in the [level] of any activity or service beyond that required by existing law shall not be required by the legislature or any state agency of units of Local Government, unless a state appropriation is made and disbursed to pay the unit of Local Government for any necessary increased costs . . . . [Const 1963, art 9, § 29.]

"The second sentence requires the state to fund any additional necessary costs of newly mandated activities or services and increases in the level of such activities or services from the 1978 base year." *Judicial Attorneys Ass'n v Michigan*, 460 Mich 590, 595; 597 NW2d 113 (1999) (citation and quotation omitted). It sets forth a clear prohibition of state action: before the state imposes a new or increased activity or service on a local unit of government, it must appropriate funds to cover any necessary increased costs. *See Adair v State*, 486 Mich 468, 479; 785 NW2d 119 (2010), *reversed in part on other grounds*, *Adair v State*, 494 Mich 852, 830 NW2d 383 (2013). This second sentence of the Headlee Amendment is commonly referred to as the "prohibition on unfunded mandates" or the "POUM" clause.

To establish a violation under the POUM clause, a plaintiff must show that: (1) the state mandated a local government to perform an activity; (2) the state-mandated local activity was imposed after adoption of the Headlee Amendment in 1978; and (3) the state-mandated local

activity was originated without sufficient state funding. Alternatively, where there already exists a state-mandated local activity that is properly funded initially, a plaintiff must show that: (1) the existing mandated local role was increased by the state; (2) this increased role was imposed after adoption of the Headlee amendment in 1978; and (3) the state-mandated role was increased without state funding for the "necessary increased costs" that would be incurred by a local government when complying with the expanded state mandate. *Adair*, 486 Mich at 480.

In this case, there appears to exist a strong argument that Senate Bills 952 and 957, in their current form, violate the Headlee Amendment's "prohibition on unfunded mandates." *First*, there is no doubt that schools districts constitute local units of government protected by the Headlee Amendment. *See Schmidt v Dep't of Educ*, 441 Mich 236, 300; 490 NW2d 584 (1992) (*citing* MCL 21.233(5)).

Second, many of the recordkeeping and reporting requirements imposed upon School Districts in Senate Bills 952 and 957 are both "mandated" and "new" "activities." In *Adair*, 486 Mich at 481, for example, the Michigan Supreme Court held that certain recordkeeping requirements were "new activities" because they "constituted an increase in the level of activity beyond that previously required," and enlarged "the volume and specificity of information that the state required to be reported . . . ." Indeed, the Court based its holding on its finding that "the amount of information collected and the manner in which the information had to be reported after [passage of the challenged law] was significantly greater and more intensive than before" and that "[c]ollecting a large amount of data or much more detailed information than was previously required constitutes an increase in the level of an activity under Const 1963, art 9, § 29; namely, the state-mandated collection, maintenance, and reporting of data to the state." *Id.*

Here, Senate Bills 952 and 957 demand that certain School Districts prepare and submit the following: (i) preplan financial reports; (ii) amended budgets; (iii) DEPs; (iv) monthly monitoring reports on revenue and expenditures; (v) EDEPs; (vi) enhanced monthly monitoring report on revenue, expenditures, cash flow, debt, other liabilities, assets, budget amendments, pupil membership, and other data relating to the finances; (vii) budgetary assumption reports; and/or (viii) periodic financial status reports. And importantly, the preparation and submittal of the afore-listed reports and/or the amount and type of information required to be contained therein is in excess of that required by existing law and/or any law existing prior to the adoption of the Headlee Amendment on November 7, 1978.

To be sure, the September 9, 2014 Senate Bill Analysis, itself, acknowledges that, at least, the preparation and submittal of EDEPs and periodic financial reports mandated by Senate Bills 952 and 957 are "new" requirements that would likely "result in increased staff and auditing costs at the local level." (*See* Ex. A at 7.) The Senate Bill Analysis further recognizes that "according to the Michigan School Business Officials, for districts that would be subject to enhanced reporting or audits, the staff time and general fund expenses to complete the reporting could be significant. It is possible that the reporting required under this package of bills would result in financial 'book-closing' to occur on a regular basis, rather than solely at year-end, which would require estimates to be made mid-year, accruals and reversals, and significant staff time, with at least one additional high-level (e.g., Assistant Finance Director or equivalent) FTE necessary at each district that was subject to enhanced reporting." (*Id.*)

Third, Senate Bills 952 and 957 contain no funding mechanism whereby the state appropriates to School Districts the funds necessary to comply with the recordkeeping and reporting requirements required thereby.

Accordingly, if the legislature does not apportion sufficient funding to cover the increased cost School Districts will incur by complying with the recordkeeping and reporting requirements mandated by Senate Bills 952 and 957, the recordkeeping and reporting portions of those Bills could be held to be unconstitutional and in violation of the Headlee Amendment's "prohibition on unfunded mandates."

B. Senate Bill 953 Circumvents The Local Financial Stability And Choice Act's Deliberate And Inclusive Process For Identifying A Financial Emergency And Appointing An Emergency Manager

The Local Financial Stability and Choice Act presently provides for an extensive, deliberate, and inclusive process by which certain state leaders may evaluate a school district's fiscal condition, declare a financial emergency, and/or appoint an emergency manager over a school district. Under section 4(1) of that Act, for example, the state financial authority is authorized to conduct a preliminary review of a school district's finances to determine the existence of probable financial stress if, among other things, the following occur:

- The school district violates sections 17 through 20 of the UBAA;
- The school district fails to provide an annual financial report or audit that conforms with the minimum procedures and standards of the superintendent of public instruction and is required under the Revised School Code and the State School Aid Act;
- The school district is in breach of its obligations under a deficit elimination plan or an agreement entered into pursuant to a deficit elimination plan; and/or
- The school district ended its most recently completed fiscal year with a deficit in 1 or more of its funds and the school district has not submitted a deficit elimination plan to the state financial authority within 30 days after the district's deadline for submission of its annual financial statement. MCL 141.1544(1) (j), (k), (l), (n), (q).

Before commencing this preliminary review, however, the state financial authority is required to provide the school district specific written notification that it intends to conduct a preliminary review. MCL 141.1544(2). The state financial authority is also required to provide an interim report of its findings to the school district within 20 days following the commencement of the preliminary review. (*Id.*) In addition, a copy of the interim report must be provided to each state senator and state representative who represents that school district. (*Id.*) The school district may provide comments to the state financial authority concerning the interim report. (*Id.*) The state financial authority is then required to prepare and provide a final report detailing its preliminary review to the local emergency financial assistance loan board. (*Id.*) And again, a copy of this final report must also be provided to each state senator and state representative who represents that school district. (*Id.*) Within 20 days after receiving the final

report from the state financial authority, the local emergency financial assistance loan board must determine if probable financial stress exists for the school district. (*Id.*)

If a finding of probable financial stress is made for a school district by the local emergency financial assistance loan board, the governor must appoint a review team for that school district consisting of the state treasurer or his or her designee, the SPI or his or her designee, the director of the department of technology, management, and budget or his or her designee, a nominee of the senate majority leader, and a nominee of the speaker of the house of representatives. MCL 141.1544(4). The governor may also appoint other state officials or other persons with relevant professional experience to serve on a review team to undertake a school district financial management review. (*Id.*)

The review team is then required to meet with the school district as part of its review. At this meeting, the review team must receive, discuss, and consider information provided by the school district concerning the financial condition of the school district. MCL 141.1545(2). In addition, the review team must hold at least 1 public information meeting in the jurisdiction of the school district at which the public may provide comment. (*Id.*) After its analysis is complete, the review team is required to submit a written report of its findings to the governor. MCL 141.1545(3). A copy of the report must also be forwarded by the state treasurer to the chief administrative officer and the governing body of the school district, the speaker of the house of representatives, the senate majority leader, the SPI, and each state senator and state representative who represents that school district. (*Id.*)

The report must opine on whether or not a "financial emergency," as that term is defined, exists within the school district. MCL 141.1545(4). The governor must then review the report and determine whether or not a "financial emergency," as that term is defined, exists within the school district. MCL 141.1546(1). Before making this determination, however, the governor, in his or her sole discretion, may provide officials of the school district an opportunity to submit a written statement concerning their agreement or disagreement with the findings and conclusion of the review team report. MCL 141.1546(2).

If the governor determines that a financial emergency exists, the governor must provide the governing body and chief administrative officer of the school district with a written notification of the determination, findings of fact utilized as the basis upon which this determination was made, a concise and explicit statement of the underlying facts supporting the factual findings, and notice that the chief administrative officer or the governing body of the school district has 7 days after the date of the notification to request a hearing conducted by the state financial authority or the state financial authority's designee. (*Id.*) Following the hearing, or if no hearing is requested following the expiration of the deadline by which a hearing may be requested, the governor, in his or her sole discretion based upon the record, must either confirm or revoke, in writing, the determination of the existence of a financial emergency. (*Id.*) If confirmed, the governor must provide a written report to the governing body and chief administrative officer of the school district of the findings of fact of the continuing or newly developed conditions or events providing a basis for the confirmation of a financial emergency and a concise and explicit statement of the underlying facts supporting these factual findings.

(*Id.*) In addition, a copy of the report must be provided to each state senator and state representative who represents that school district.

A school district for which a financial emergency determination has been confirmed to exist may, by resolution adopted by a vote of 2/3 of the members of its governing body elected and serving, appeal this determination within 10 business days to the Michigan court of claims. MCL 141.1546(3). The court must set aside a determination of financial emergency by the governor if it finds that the determination is either of the following: (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. (*Id.*)

Upon the confirmation of a finding of a financial emergency, the governing body of the school district is required to, by resolution within 7 days after the confirmation of a finding of a financial emergency, select 1 of the following local government options to address the financial emergency: (a) the consent agreement option; (b) the emergency manager option; (c) the neutral evaluation process option; or (d) the chapter 9 bankruptcy option. MCL 141.1547(1).

In this case, if enacted, Senate Bill 953 would bypass this entire deliberate and inclusive process as well as the due process protections contained therein (*i.e.*, the right to judicial review). The Bill would allow the State Treasurer, in a situation in which a school district was subject to an EDEP but failed to submit an EDEP or comply with its requirements, to unilaterally declare that a financial emergency exists within such school district and recommend that the governor appoint an emergency manager to address the purported financial emergency. *Whether Senate Bill 953 violates the state and/or federal constitutions or conflicts with other state or federal statutes is a question outside the scope of this summary and analysis.*