

## REPORT TO THE CITY COUNCIL AND SUCCESSOR AGENCY

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**DATE:** November 12, 2013

**TITLE:** Financial Update - Fiscal Year 2013/14

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### RECOMMENDATION

**Consider the FY 2013/14 Financial Update and provide direction to staff.**

### DISCUSSION

The Finance Department has been working with the auditors to close out fiscal year 12-13. These numbers were provided to City Council at the November 5<sup>th</sup>, 2013 meeting (Exhibit 1). The Consolidated General Fund ("General Fund") includes the following three funds: 001-General Fund, 211-Health & Wellness Center Operations, and 245-Public Safety. The end result, subject to audit adjustments, is that the ending General Fund balance, as of 6-30-13, is estimated to be \$3,155,703. This ending balance becomes the beginning fund balance for the following fiscal year (FY 13-14).

The City Council adopted the Fiscal Year ("FY") 2013-14 Operating Budget with the following assumptions:

Beginning Fund Balance	\$ 4,150,838
Estimated Revenues	16,295,409
Estimated Appropriations	(18,346,062)
Net Transfers Out	<u>( 209,504)</u>
Projected Ending Fund Balance	<u>\$ 1,890,681</u>

The adopted budget, when transfers out are included, assumed the use of \$2,260,157 in General Fund reserves during FY 13/14. The beginning General Fund balance, as of 7-1-13, is estimated to be \$3,155,703 (Exhibit 2). This is a decrease in beginning General Fund balance of \$995,135, as compared to the originally estimated \$4,150,838.

Transfers in/out within a City's budget represent the allocation of City resources to specific uses. For example, in FY 12-13, the City transferred \$400,000 out of its General Fund and transferred \$400,000 in to the City's Self Insurance General Liability Fund. Exhibit 1 includes a list of Operating Transfers In / Out for FY 12-13.

The following ending balance results when the estimated beginning fund balance is used with the adopted FY 2013-14 Operating Budget (Exhibit 3):

Beginning Fund Balance	\$ 3,155,703
Estimated Revenues	16,295,409
Estimated Appropriations	(18,346,062)
Net Transfers Out	<u>( 209,504)</u>
Projected Ending Fund Balance	<u>\$ 895,546</u>

The City Manager asked City staff to evaluate the FY 13-14 budget and make recommendations regarding budgeted revenues and expenditures. This included adjusting revenues to anticipated actual revenues, as well as adding back expenditures that were arbitrarily cut from the budget.

The estimated changes to the FY 13-14 budget are dramatic. Estimated revenues are expected to be \$2,692,945 lower than the adopted FY 13-14 budget, for a revised expected General Fund revenue amount, including transfers in, of \$13,902,464.

Expenditures, when evaluated, included adding back in many costs that were cut from the budget, even though the City has contractual obligations to pay some of these expenditures. The total increase added back to the Appropriations is \$1,479,900. This number is net of cost savings that staff has already implemented. These changes resulted in a revised expected General Fund expenditure amount, including transfers out, of \$20,135,466.

The following is a summary of the City's FY 13-14 budget, including the Revenue & Expenditure adjustments (Exhibit 4):

Beginning Fund Balance	\$ 3,155,703	
Estimated Revenues	13,902,464	Including transfers in
Estimated Appropriations	<u>(20,135,466)</u>	Including transfers out
Projected Ending Fund Balance	<u>(\$ 3,077,299)</u>	

The estimated FY 13-14 revenues include one-time revenues of \$682,589. This was the final piece of the Developer Reimbursement Fee from the Health & Wellness Center. This represents a structural deficit of approximately \$6.9 million, when the one-time revenues are excluded, for FY 13-14. (\$13,902,464 minus \$682,589 minus \$20,135,466.)

Staff developed 100+ ideas on ways to save money, increase revenues, and increase cost recovery (Exhibit 5). Staff came up with every idea they could think of, including ideas that directly harm the livelihood of themselves and their families. Staff is not advocating for, or against, any of these ideas. Many of these ideas have been previously suggested by Michael Busch, of Urban Futures, as well as the City's Finance Committee. These ideas are not mutually exclusive. The intention was to present City Council with various options and ask for Council direction.

Another extremely important concern is that General Fund cash was \$1,533,588 as of 9/30/13 and \$3,555,001 as of 6/30/13 (Exhibit 6). The City of Desert Hot Springs is projected to run out of General Fund Cash by March 31, 2014. **This makes it necessary to make difficult decisions quickly in order to turn around the financial condition of the City.** The City will need to take steps to declare a Fiscal Emergency very soon. **Staff has issued a "Notice of Public Hearing" for a Fiscal Emergency Public Hearing to be acted on at the Regular City Council Meeting on November 19, 2013 if the City Council should decide to do so. If not, the Public Hearing may be continued to a future meeting.**

***Steve Quintanilla, City Attorney, provided the following information:***

### **Municipal Bankruptcy**

Under Federal and State law, in order for the City to file a bankruptcy petition, the City must first either:

- (a) Participate in a neutral evaluation process; or
- (b) Declare a fiscal emergency.

## **City Attorney's Information (continued):**

### **1. Neutral Evaluation Process**

The City may initiate the neutral evaluation process if it is unable, or likely to be unable, to meet its financial obligations. The City begins this process by providing notice by certified mail to all interested parties. The City and the interested parties select a neutral evaluator, whose qualifications and responsibilities are specified in the Government Code. During the neutral evaluation, which is limited to 60 days unless extended, the City and the interested parties must negotiate in good faith and must keep the negotiations confidential, subject to exceptions. If the neutral evaluation process ends without having resolved all disputes with creditors, the City may file a bankruptcy petition.

### **2. Fiscal Emergency Process**

To file a bankruptcy by declaring a fiscal emergency, the City must first hold a public hearing on the fiscal condition of the City. The City may file a bankruptcy petition if, following the public hearing, the City Council:

- (a) Declares a fiscal emergency; and
- (b) Adopts a resolution finding that:
  - (0) Absent bankruptcy protection, the financial state of the City jeopardizes the health, safety, or well-being of the residents, and
  - (1) The City is or will be unable to pay its obligations within the next 60 days.

In municipal bankruptcy cases, the evaluation is based on an analysis of existing and projected cash flow. The City will be considered insolvent if it is generally not paying its debts as they become due or is unable to pay debts as they become due.

### **3. Background Cases**

#### *City of Vallejo Case*

The City of Vallejo, California, filed bankruptcy in 2008 to deal with burdensome labor agreements. The bankruptcy court found, and the bankruptcy appellate panel affirmed, the city's insolvency when it had insufficient unrestricted funds, determined on a cash flow basis, to pay its debts due within the next year; the court denied the unions' motions to dismiss the petition.

#### *City of Bridgeport Case*

In contrast to the Vallejo case, the City of Bridgeport, Connecticut, filed bankruptcy in 1991 as part of a strategy to reject certain burdensome labor agreements. At that time, the city projected a budget deficit of \$16 million. The bankruptcy court, however, dismissed the petition, finding that the city's existing cash position and forecasted revenues from preexisting taxes failed to support the city's contention that it would be unable to pay its debts as they became due.

### **4. Petition Process**

A Chapter 9 case is commenced by the filing of a bankruptcy petition in the local United States Bankruptcy Court. A filing fee of \$1000 must be paid at the time of filing. Along with the petition, the City must file a list containing the name, address, and claim of the creditors that hold the 20 largest unsecured claims. A list containing the names and addresses of all the City's creditors

### **City Attorney's Information (continued):**

also needs to be filed within the time ordered by the court. Schedules of assets and liability, current income and expenditures, and a statement of financial affairs and other documents required in other cases are not required in a Chapter 9 case. A Notice of Commencement of a Chapter 9 case must be published in a newspaper of general circulation in the district where the case is filed, and in a newspaper of general circulation among bond dealers and bondholders as the court designates, once a week for 3 successive weeks.

The bankruptcy court has jurisdiction over bankruptcy cases. In municipal cases, the Chief Judge of the Court of Appeals for the Circuit designates the judge to whom a Chapter 9 case will be assigned. 11 USC §921(b).

#### **5. Effect of Filing Petition**

The filing of the bankruptcy petition itself ***is not*** an automatic adjudication of the eligibility of the municipality for bankruptcy relief. Creditors may object or move to dismiss the petition on the grounds that the City is not insolvent or that the petition was not filed in good faith. If the petition is not dismissed, the court will order bankruptcy relief.

The filing of a Chapter 9 petition ***does not*** abrogate the power of a state to exercise control over a municipality through exercise of its political or governmental powers, including expenditure of revenues incidental to exercise of those powers. The Bankruptcy Code specifically prohibits the Bankruptcy Court from issuing any order that would interfere with the exercise of the municipality's governmental powers or disposition of its revenues. In the Chapter 9 filed by the County of Orange, for example, the Bankruptcy Court declined to order the county to pay counsel hired by various subcommittees representing special interest groups on the grounds that to do so would be an interference with the county's authority to control its expenditure of revenue. Similarly, a court should not interfere with a city's unilateral reduction in retiree health benefit payments if the decision is an exercise of the city's governmental powers.

#### **6. Automatic Stay**

**One of the main benefits for the City in filing a bankruptcy case is the automatic stay, which acts as an injunction of any action against a debtor to collect preexisting debts or to obtain property of the debtor to satisfy such debts.** The scope of the automatic stay is enlarged in municipal cases to cover an action by a creditor against an officer or inhabitant of the municipality seeking to collect a claim against the municipality or to enforce a lien on or arising out of taxes due to the municipality.

Special revenues include receipts from transportation or utility services, special excise taxes, incremental receipts from tax benefit districts, and project financing taxes. **The automatic stay does not extend to the application of pledged special revenues to payment of indebtedness secured by those revenues.**

The Bankruptcy Code extends any pre-petition consensual lien against special revenues to funds received post-petition and precludes diversion of such funds for general municipal purposes. This is in contrast to the general rule that a pre-petition security interest does not extend to property acquired post-petition.

## City Attorney's Information (continued):

### 7. Repayment Plan

**The purpose of bankruptcy reorganization is to provide the City with a respite from creditor pressure in order to allow the filing and confirmation of a repayment plan. In a municipal bankruptcy, whether a plan gets confirmed generally hinges on the extent to which the municipality will be required to exercise its taxing authority to generate a repayment that will be fair and equitable to creditors. In Chapter 9, only the debtor municipality has the right to propose a plan. This rule is necessary to preserve the municipality's duty to retain control over its political affairs. Although a creditor may not propose any reorganization plan, it may petition the court to set a deadline for the municipality to file a plan after which time the case would be dismissed if no plan had been filed.**

Under a Chapter 9 filing, it is mandatory that the plan:

- (a) Designate classes of creditors;
- (b) Specify what classes of creditors are unimpaired by the plan;
- (c) Specify the treatment of each class of impaired creditors;
- (d) Provide for uniform treatment of creditors in each class; and
- (e) Set a means for implementation of the plan provisions.

Among the most important plan confirmation requirements for a municipal bankruptcy are feasibility and that the debtor is not prohibited by law from taking any action necessary to carry out the plan.

### 8. Labor Agreements

During the *Orange County Employees Ass'n v County of Orange* bankruptcy case, the county attempted to abrogate its Memorandums of Understanding with various county employee collective bargaining units by terminating personnel on the basis of necessity, without regard to seniority. The Bankruptcy Court ruled in *Orange County Employees Ass'n* that the county was required to negotiate with its employee collective bargaining units before modifying its labor agreements. The county's ability to modify the agreements was restricted to those emergency circumstances that:

- ( ) A declared emergency must be based on an adequate factual foundation;
- (a) The agency's action must be designed to protect a basic social interest and not benefit a particular individual;
- (b) The law must be appropriate for the emergency and obligation; and
- (c) The agency decision must be temporary and limited to the immediate exigency that caused the action.

California Government Code Sections 53760 et seq. govern declarations of **fiscal emergencies**. In particular, **Section 53760.5** provides that a local public entity may declare a fiscal emergency by adopting **a resolution** by a **majority** vote of the governing board at a **noticed public hearing** that includes **findings** that the financial state of the local public entity jeopardizes the health, safety, or well-being of the residents of the local public entity's jurisdiction or service area absent the protections of Chapter 9. The resolution must also make **findings** that the public entity is or will be unable to pay its obligations within the next 60 days. Prior to a declaration of fiscal emergency and adoption of a resolution, the local public entity shall **place an item on the agenda of a noticed public hearing** on the fiscal condition of the entity to take public comment.

If none of the above alternative works, the City may need to consider disincorporation. The City of Desert Hot Springs would become an unincorporated community within the County of Riverside. The County is required to provide minimal services such as Police, Fire & Sanitation. Levels of service would dramatically decrease. The unincorporated community of Desert Hot Springs would be a small community in a large County. However, the financial costs to residents, especially costs for citywide sworn & non-sworn staff, ongoing legal fees and insurance costs, would see a rapid decrease.

The Finance Committee recommended a process called Zero-Based Budgeting ("ZBB"). Staff concurs it would be best to start fresh, from scratch, and with Council and staff working together, develop strategies to turn the City's financial ship around. Staff recommends starting a zero-based budget, as soon as possible, for the period January 1, 2014 through June 30, 2015.

### **FISCAL IMPACT**

**The City must make major changes to its ongoing costs, immediately.**

### **EXHIBIT(S)**

1. Consolidated General Fund Budget FY 12-13
2. DRAFT Financial Summary FY 12-13 – Best Estimate for Beginning Fund Balance 7-1-13
3. DRAFT Adopted Budget with Reduced Beginning Fund Balance FY 13-14
4. DRAFT Expected Budget FY 13-14 with Revenue & Expenditure Adjustments
5. Budget Savings, Cost Recovery & Revenue Enhancement Ideas
6. City of DHS Cash Position as of 9-30-13 & 6-30-13