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# Executive Summary of AB 506

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## **I. How Does AB 506 Change Existing Law?**

Prior to the signing of AB 506, a public agency in California could file for protection under chapter 9 of the federal bankruptcy code without any state approval or pre-conditions. Under this recent legislation, fiscally distressed public agencies may still resort to bankruptcy protection, but before the public agency may file for protection, it *must* either 1) engage in a neutral evaluation process with its creditors with the help of a mediator; or 2) declare a fiscal emergency. Though this legislation is not a radical change, it does require a public agency to engage in more process prior to filing for bankruptcy protection in the hopes that the parties, with the aid of a specially trained “neutral evaluator,” may be able to resolve “municipal and state business and financial issues in a timely, fair, and cost-effective manner [which] is an integral part of a successful government and is in the public interest.”<sup>1</sup>

This recent legislation is in direct response to the City of Vallejo’s filing for bankruptcy protection in 2008. Though Vallejo has just emerged from bankruptcy,<sup>2</sup> AB 506 was drafted “in response to the length, cost, and consequences of Vallejo’s bankruptcy and the potential for additional municipal bankruptcy filings. . . .”<sup>3</sup> The new legislation attempts to cast bankruptcy protection as a last resort rather than a public agency’s first option. Additional analysis of the requirements of this new legislation is the subject of an upcoming Public Law Group™ White Paper.

## **II. Key Points of the Legislation**

### **A. Effective Date**

The legislation was signed on October 9 and filed with the Secretary of State on October 11, 2011. It is effective 90 days after filing with the Secretary of the State, which is January 9, 2012.

### **B. Neutral Evaluation**

If a public agency believes that it is or will be unable to meet its financial obligations when those obligations become due, the public agency may initiate the neutral evaluation process.<sup>4</sup> A public agency is defined as “any county, city, district, public authority, public agency or other entity, without limitation, that is a municipality as defined in Section 101(40) of

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<sup>1</sup> AB 506, 2011-2012 Session, Section 1(f) (2011).

<sup>2</sup> Carolyn Jones, *Vallejo’s Bankruptcy Ends After 3 Tough Years*, S.F. CHRON, Nov. 15, 2011, at C5.

<sup>3</sup> *Senate Rules Committee, Third Reading on AB 506 as Amended September 8, 2011*, 2011-2012 Session (2011).

<sup>4</sup> Cal. Gov. Code §§ 53790 *et. seq.*

the United States Code (bankruptcy), or that qualifies as a debtor under any other federal bankruptcy law applicable to local public entities.”<sup>5</sup> The neutral evaluation process is comprised of the following steps:

1. The public agency shall notify all interested parties by certified mail of its request for neutral evaluation.
2. Interested parties<sup>6</sup> shall respond within 10 business days of receipt of request.
  - If an interested party or all interested parties fail to respond within 10 business days, the party or parties waived their right to participate in the neutral evaluation process.
3. All responding interested parties and the public agency shall mutually select a neutral evaluator through a mutually agreed upon process. If the parties are unable to mutually select a neutral evaluator, the public agency shall furnish the names and backgrounds of five qualified neutral evaluators. A majority of interested parties shall strike up to four names from the list and the remaining candidate shall serve as the neutral evaluator.
4. All parties shall participate in the neutral evaluation and negotiations in good faith.

*Comment:* Good faith under this statute is similar to the good faith requirement under the Meyers-Milias Brown Act (“MMBA”) as it means that the parties will participate in the evaluation process with an “intent to negotiate toward a resolution . . . including the timely provisions of complete and accurate information to provide the relevant parties through the neutral evaluation process with sufficient information . . . .”<sup>7</sup> The new law does not explain the consequences for the parties who fail to participate in the neutral evaluation process in good

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<sup>5</sup> 11 USC § 101(40) defines a municipality as a “political subdivision or public agency or instrumentality of a State.” School districts are not public entities for purposes of this legislation.

<sup>6</sup> An Interested Party is defined by the statute as “a trustee, a committee of creditors, an affected creditor, an indenture trustee, a pension fund, a bondholder, a union that, under its collective bargaining agreements, has standing to initiate contract or debt restricting negotiations with the municipality, or a representative selected by an association of retired employees of the public entity who receive income from the public entity convening the neutral evaluation.” Additionally, “a local public entity may invite holders of contingent claims to participate as interested parties in the neutral evaluation if the local public entity determines that the contingency is likely to occur and the claim may represent five million dollars (\$5,000,000) or comprise more than 5 percent of the local public entity’s debt or obligation, whichever is less.”

<sup>7</sup> Cal.Gov. Code § 53760.1(d) as amended.

faith. In the legislative summaries of earlier versions of the bill, the bill would have prohibited a public agency from filing a petition under chapter 9 if the neutral evaluator determined that the public agency failed to participate in good faith mediation.<sup>8</sup> This language is absent from the final version of the legislation.

5. Each party shall send a representative to all neutral evaluation meetings and the representative shall have the authority to settle and resolve disputes or shall be in the position to present any proposed settlement plan or plan of readjustment to their constituents.
6. The process is confidential unless otherwise agreed to by the parties or disclosure is deemed necessary by the judge presiding over any subsequent bankruptcy.

### **C. Timing**

7. The neutral evaluation process *shall not last for more than 60 days* following the date the neutral evaluator is selected, unless the public agency or a majority of interested parties chose to extend the process for up to an additional 30 days.

*Comment:* The “majority of interested parties” is not defined in this legislation, which will cause confusion as “majority” can be construed in several different ways. For example, is the majority determined by the dollar amount of contingent claims held by a party or parties or is majority determined by sheer number of those holding the claims? A bondholder may hold a greater dollar amount of contingent claims, but an employee organization may represent a greater number of individuals holding smaller claims. This will become an issue during the neutral evaluation process as the interested parties often act as a majority and creditors will oftentimes have different agendas and goals in settlement.

### **D. Ending the Neutral Evaluation Process**

8. The neutral evaluation process shall end if:
  - The parties execute a settlement agreement OR
  - The parties reach an agreement or proposed plan of readjustment that requires the approval of a bankruptcy judge OR

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<sup>8</sup> *Assembly Committee on Local Government on AB 506 as Amended March 31, 2011, 2011-2012 Session (2011) (Cameron Smyth, Chair).*

- The neutral evaluation process has exceeded the 60 days and the parties have not reached an agreement and no one wishes to extend the process further; OR
  - As stated above in No. 2, the public agency received no responses from interested parties; OR
  - The fiscal condition of the public agency deteriorates to the point that a fiscal emergency is declared and necessitates the need to pursue the protections of bankruptcy.
9. If the neutral evaluation process period concludes without an agreement and if the public agency believes that a bankruptcy filing is necessary, it may file a petition seeking the protections of federal bankruptcy laws.

**E. Fiscal Emergency Alternative**

10. A public agency may bypass the neutral evaluation process if it declares a fiscal emergency.
11. The declaration of fiscal emergency must be adopted by resolution by a majority vote of the governing body at a noticed public hearing.
12. The declaration of fiscal emergency must include 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 protections of Chapter 9” of the federal bankruptcy code.<sup>9</sup> Additionally, the resolution of the public agency must include a finding that the public agency will be unable to pay its obligations within the next 60 days.
13. Before such declaration can be made, the public agency must comply with the requirements of the Brown Act and place the item on the agenda of a noticed public hearing where the public may comment on the state of the agency’s fiscal condition.

*Comment:* The declaration of fiscal emergency under this legislation appears to be a different animal than the declaration of fiscal emergency that stems from a public agency’s inherent police power. Here, the declaration of fiscal emergency appears to be a procedural step before a public agency may file for bankruptcy protection under chapter 9. Under the declaration of fiscal

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<sup>9</sup> Cal.Gov. Code § 53760.5 as amended.

emergency that has been developed in the case law and as illustrated in the *Sonoma County Organization of Public Employees v. County of Sonoma*, the declaration of a fiscal emergency may allow legislative impairment of a contract in the face of a court challenge under the Contracts Clause of the constitution.<sup>10</sup> Though a public agency has wide latitude in the determining what it believes to be a fiscal emergency, the impairment of the contract itself must be appropriately tailored to the emergency it was designed to address and that the result must be reasonable.<sup>11</sup> 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.’”<sup>12</sup> Under this new legislative scheme, the declaration of fiscal emergency is not a precursor to the impairment of contracts, but rather a procedural step prior to the public agency filing for bankruptcy protection.<sup>13</sup>

## F. Costs

The public entity is responsible for 50 percent of the cost of the neutral evaluation and creditors are responsible for the balance. Under the statute, creditor is defined more narrowly than an “interested party” as discussed in footnote 3, *infra*. A creditor is defined as either of the following: 1) “and entity that has a noncontingent claim against a municipality that arose at the time of or before the commencement of the neutral evaluation process and whose claim represents at least five million dollars (\$5,000,000) or comprise more than 5 percent of the local public entity’s debt or obligation, whichever is less” or 2) “An entity that would have a noncontingent claim against the municipality upon the rejection of an executor contract or unexpired lease in a Chapter 9 case and whose claim represents at least five million dollars (\$5,000,000) or comprise more than 5 percent of the local public entity’s debt or obligation, whichever is less.”<sup>14</sup>

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<sup>10</sup> *Sonoma County Organization of Public Employees v. County of Sonoma*, 23 Cal.3d 296 (1979).

<sup>11</sup> *Id.*

<sup>12</sup> See Jon Holtzman et al. *Declarations of Fiscal Emergency: A Resurging Option for Public Entities Attempting to Deal with the Current Economic Climate*, CALIFORNIA PUBLIC LAW JOURNAL, Vol. 34, No. 2, Winter 2011 citing *Buffalo Teachers Federation v. Tobe*, 464 F.3d 363, 371 (2d Cir. 2006).

<sup>13</sup> For further discussion, please see Charles Sakai et al. *We’re Bankrupt, Now What?*, CPER JOURNAL No. 199 (May 2010). The city of Vallejo rejected its labor contracts under the provisions of bankruptcy law. Under bankruptcy law, the court determines whether the contract burdens the estate and after balancing the equities, whether the equities favor the rejection of the agreement. *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 526 (1984).

<sup>14</sup> Cal.Gov. Code § 53760.1 (b) as amended.

### **III. Conclusion**

Under AB 506, a public agency in California may still file for bankruptcy protection under chapter 9, but it must now comply with procedural hurdles prior to any filing. As seen in the County of Orange or the City of Vallejo, bankruptcy is not a panacea as it can be costly and time-consuming. Though this legislation is a significant step towards avoiding bankruptcy, the neutral evaluation process also helps to make the bankruptcy process, if still necessary, more quick and efficient. The neutral evaluation process duplicates a number of requirements a public agency must meet in order to be eligible for bankruptcy protection. By participating in the neutral evaluation process, the public agency will have “its ducks in a row” prior to any bankruptcy filing and will also have a plan of readjustment at the ready for emerging from bankruptcy protection. This process helps to engage all the parties sooner in coming up with a solution instead of litigating a solution. This process is by no means perfect as it leaves many unanswered questions including the power and responsibilities of the neutral evaluator, the composition of the “majority of interested parties” and how this ultimately affects the outcome of mediation, and whether it is possible for parties to reach a settlement of such complex issues in such short time lines.

The Public Law Group™ White Paper with greater analysis this new piece of legislation will be available shortly. For a copy of the White Paper, please contact Brian Gillis at [bgillis@publiclawgroup.com](mailto:bgillis@publiclawgroup.com).