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1/24/2013

TO: Local Agency Formation Commission

FROM: George J, Spiliotis, Executive Officer

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**SUBJECT: COMMISSION WORKSHOP ON MUNICIPAL DISINCORPORATION**

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PRIOR AGENDAS/RELATED ACTIONS: None.

Fiscal stresses resulting from the economic downturn coupled with the State's failure to restore vehicle license fee revenue to recently incorporated cities have prompted interest in the subject of disincorporation. Only historical oddities until recently, municipal bankruptcy and disincorporation have become topics of articles, public meetings and workshops. At its October meeting, the Commission requested a future staff presentation on disincorporation.

**CALAFCO Workshop:**

In June of 2012, a CALAFCO University course on municipal disincorporations and consolidations was conducted in Los Angeles. The course was coordinated by staff of the Orange County LAFCO with participation of staff from Riverside and San Bernardino LAFCOs and attorneys Michael Colantuono and Mathew Richardson. Selected course materials and other related information are attached to this report.

The course opened with a brief discussion of the differences between bankruptcy, disincorporation and consolidation and an overview of the statutory process for the last two. Following this opening session, attendees were divided and rotated through four discussion groups to explore various aspects of the disincorporation process. One of the objectives of the course was to utilize the group discussions to identify shortcomings in current statutes and opportunities for clarification or improvement in the process through legislative changes or local policies. It should be noted that the last disincorporation processed in the State, Cabazon in 1971, was processed under a previous set of statutes. There has not been a disincorporation processed under current law.

**Disincorporation Process:**

The process of disincorporation is very similar to that of other changes of organization, such as annexation and incorporation. Disincorporation can be initiated by resolution of an affected agency or by petition of landowners or registered voters. An affected agency could be the subject city, the county or a special district

whose territory or sphere of influence overlies any territory of the disincorporating city. If initiated by petition, the signature threshold for disincorporation is the highest called for in CKH, 25 percent of the registered voters or landowners, the same as that required to initiate incorporation proceedings. Disincorporation proceedings cannot be initiated by LAFCO.

Regardless of how disincorporation is initiated, the proponents must be prepared to indicate what expectations they have and demonstrate why disincorporation is the preferred course of action. In some cases, bankruptcy would be a more appropriate option. If the problem was a single calamitous event, such as a large judgment, or overly-burdensome debt, the bankruptcy process might afford a restructuring of obligations that could provide the city with sufficient cash flow to continue its existence. Disincorporation cannot eliminate or restructure debt.

The initiating documents for disincorporation must be filed with LAFCO along with other application requirements. The most significant of these is the Plan of Services (POS). The POS provides information to the Commission and the public regarding the scope and level of services to be provided to the affected area upon disincorporation. The POS should compare existing city services to those that will be provided by successors, as well as enumerate any services that would be discontinued. The plan should also discuss the disposition of employees.

Typically, most or all municipal functions would be assumed by the County. In some circumstances services could most efficiently be assumed by a special district. The plan of services would identify the preferred provider for each service. It is imperative that the proposed successor to city services participate in the preparation of the POS, regardless of how the proposal is initiated. This participation is essential, whether or not the successor favors disincorporation.

The plan of services should also include a fiscal component. It should be noted that there is no statutory requirement for a disincorporation fiscal analysis as there is for an incorporation. Such an analysis, however, is an important piece of information that should be considered by the successor agency and the Commission. The fiscal analysis should compare the revenues that would accrue to the successor service provider(s) to the cost of services that would be assumed. The cost should be based on the level of services that would be provided post-disincorporation. The fiscal analysis should also identify city assets and any debt or other significant obligations incurred by the city, such as space and equipment leases, pension obligations and other contracts.

The plan of services and other pertinent information would be transmitted to affected agencies for review and comment. Staff would

prepare an analysis of the proposal and make a recommendation. The Commission would hold one or more public hearings and act on the proposal. The disincorporation could be approved, most likely with some terms and conditions, or denied.

A range of terms and conditions can be applied to a disincorporation. Terms and conditions such as designating the County as the successor agency and establishing an effective date for disincorporation would be standard. Other terms and conditions could be applied to meet the unique circumstances of a particular proposal. For example, the Commission could approve disincorporation subject to the following:

- the continuation of existing taxes, assessments or charges
- voter approval of new special or general taxes or assessments
- failure of a tax measure that would enable a city to remain incorporated
- the continuation of a particular service
- disposition of property

The list above represents a range of possible conditions but is not intended to be all-inclusive.

Any party may request reconsideration of the Commission's determination within 30 days of action. If such a request is made, a noticed public hearing must be held on the request.

If ultimately approved by the Commission, the Board of Supervisors must submit the disincorporation to the voters for confirmation. There is no protest hearing. Any terms and conditions applied by the Commission become part of the ballot measure. A simple majority determines the outcome of the measure. From the time a proposal is filed to the time it is presented to the voters can take from nine months to well over a year, depending on many factors, such as the completeness of the original submittal, the complexity of the proposal, how many hearings are conducted by the Commission, whether reconsideration is requested, the timing of election dates, etc.

**Post-Election:**

If the disincorporation is confirmed at election, either the Commission or the County must prepare a certified statement regarding the city's debt, the balance in the city's treasury and the amount of any taxes and other payments due the city that have not yet been paid. Upon the effective date of disincorporation, the successor (the County) is responsible for winding up the affairs of the disincorporated city, much like the executor of an estate. A special fund is established by the County for this purpose. The successor must utilize the assets of the city to pay off debt and other obligations.

If there are insufficient funds to pay indebtedness incurred by the city, the current statute calls for the levy of taxes on property within the former city. This statute, however, conflicts with voter approved constitutional provisions of Propositions 13 and 218, thus is unenforceable. The Commission could, however, condition approval of disincorporation upon voter passage of a tax measure. The disincorporation process cannot be used to discharge debt. That is the exclusive function of bankruptcy proceedings. No term or condition or other action of the Commission can impair the rights of bondholders or other creditors.

Funds remaining after all obligations have been satisfied must be transferred to school districts, community college districts or special districts within the boundaries of the former city or used to improve roads within that territory. The distribution among those entities is entirely at the discretion of the Board of Supervisors.

**A Tale of Two (types of) Cities:**

At present, the focus has been on the potential for disincorporation of our recently incorporated cities due to the elimination of VLF revenue. Disincorporation of these recently formed cities is neither a simple process nor an easy decision and should not be taken lightly. But it should be noted that disincorporation of an established city would be far more complex. An older established city would likely have the following characteristics:

- large employee base with one or more collective bargaining agreements
- Multiple funds with interfund transfers and loans
- Former redevelopment agency wind-down issues
- bonded indebtedness or other debt instruments
- Numerous contracts with vendors and contractors
- Long-term projects in progress
- A wider array of services

Each of the above would add to the complexity of analysis, processing time and degree of effort required of the successor agency.

**Alternative:**

As noted earlier, the CALAFCO University Workshop held in June 2012 included information on disincorporation and consolidation. Presented with the specter of disincorporation, it would not be unreasonable to at least give some consideration to consolidating two cities. Commission policy sets out the following hierarchy of changes of organization in descending order of preference:

- Annexation to an existing city
- Annexation to an existing multiple purpose special district

- Annexation to an existing single purpose special district
- Formation of a County Service Area
- Formation of a new district
- Incorporation of a new City
- Unincorporated Community

Although city consolidation is not explicitly included in the above list, preference for services provided by an existing city is implied. The Commission can neither compel nor initiate a consolidation proposal. However, those interested in pursuing disincorporation should at least give some thought to consolidation and the commission should also consider whether it is a reasonable alternative before approving disincorporation. The process is very similar to that for disincorporation. One significant difference, however, is that the petition threshold for initiation by voters is only 5 percent, much lower than the 25 percent required to initiate disincorporation. This indicates the Legislature's preference for consolidation.

**Summary:**

Disincorporation is not a simple process and the decision to enter into it should not be taken lightly. It is time consuming and requires a significant effort by the subject city and successor, both before and after Commission action. It is the position of staff that disincorporation should be considered the avenue of last resort, to be taken only when all other reasonable alternatives have been pursued or considered. The Commission does not have policies or procedures that specifically address disincorporation. If presented with such a proposal, staff will proceed as indicated above, unless directed otherwise by the Commission. If the Commission desires specific policies prepared for disincorporation proposals, it should direct staff to do so and provide some guidance.

Respectfully Submitted,

George J. Spiliotis  
Executive Officer