CITY OF ISLETON

THE BASICS OF BANKRUPTCY & DISINCORPORATION

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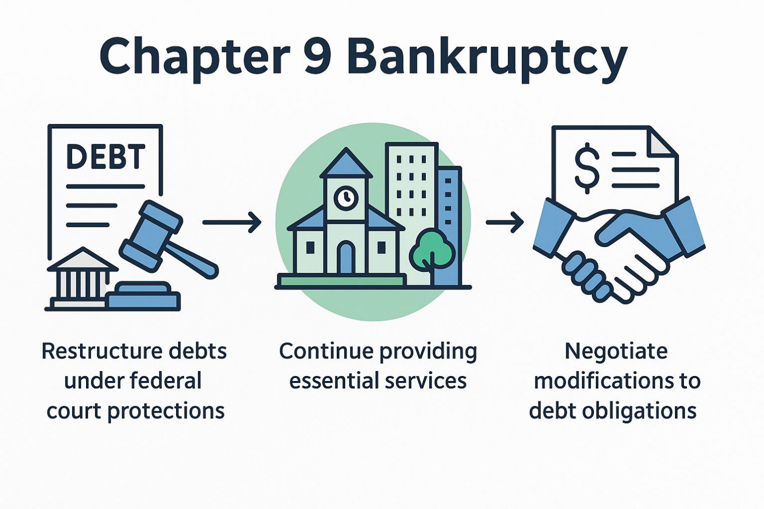
A LAW FIRM FOUNDED ON THE PRINCIPLE OF SERVICE

BANKRUPTCY

- What is Bankruptcy?
  - Bankruptcy is a legal process that allows individuals, businesses, or government entities that cannot pay their debts to seek judicial relief and financial reorganization under federal law by the Bankruptcy Court
  - Governed by Title 11 of the United States Code (the Bankruptcy Code), which establishes different types or chapters of legal proceedings depending on the type of debtor
- It provides:
  - A structured framework for resolving debts under court supervision
  - An opportunity for the debtor to obtain a fresh start
  - Fair treatment of creditors through orderly distribution of available assets

MUNICIPAL BANKRUPTCY CHAPTER 9

- Municipalities, like the City of Isleton, can file for bankruptcy under Chapter 9 of the United States Bankruptcy Code
- If successful, it would allow the City to:
  - Restructure debts under protection of the federal bankruptcy court
  - Continue operating essential public services while developing a plan to repay creditors over time
  - Negotiate modification of debt obligations without dissolving the City



BASIC REQUIREMENTS TO FILE FOR CHAPTER 9 BANKRUPTCY

- Eligibility is not automatic – the City must prove that it meets the statutory requirements to file for Chapter 9 bankruptcy
- Basic requirements:
  - Be a municipality (city / county / special district)
  - Be specifically authorized by State law (California allows with additional requirements)
  - Be insolvent:
    - unable to pay debts as they come due; or
    - unable to pay debts based on projections for the current or coming year
  - Show a genuine intent to adjust debts through a plan, including increased revenue sources or funding mechanisms
    - Cannot be to merely delay creditors or gain leverage

ADDITIONAL REQUIREMENTS TO FILE FOR BANKRUPTCY

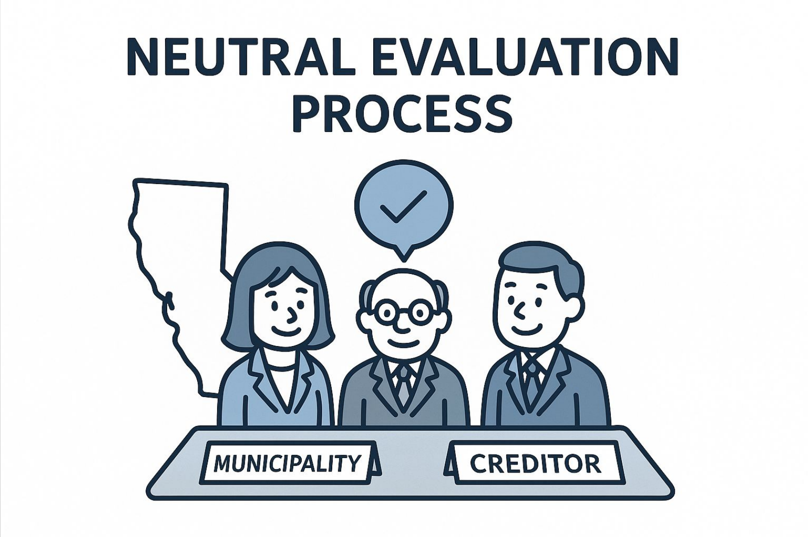
- Must show at least one of the following:
  - Agreement: obtain majority agreement from each class of claims affected by its plan;
  - Good-faith negotiation: attempted but failed to reach agreement with creditors (often litigated);
  - Impracticability: show that negotiation were impracticable under the circumstances; or
  - Creditor conduct: reasonably believe that creditors would act to obtain preferential treatment.
- Good-Faith Filing
  - Must be filed in good faith
  - City’s actions must be consistent with requirements of Chapter 9
  - Scope and severity of financial distress must justify the use of Chapter 9
  - Must show made sufficient efforts to negotiate and consider alternative before filing for Chapter 9 protections

ADDITIONAL RULES TO FILE CHAPTER 9 BANKRUPTCY IN CALIFORNIA

- In California, before filing for Chapter 9 bankruptcy protections, the municipality must first either:
  - Pursue a neutral evaluation process; or
  - Declare a fiscal emergency

NEUTRAL EVALUATION PROCESS

- Facilitated mediation between the municipality and creditors before a neutral evaluator agree upon by the parties (Gov. Code §53760.3)
- Key features:
  - Participants must negotiate in good faith
  - Proceedings are confidential
  - 60 days in duration (can be extended another 30 days)
- Evaluator may require a proposed plan of readjustment – a framework outlining:
  - Overview of financial position
  - Summary of major debts
  - Plan to address (e.g., adjustments, new revenue, or restructuring)



FISCAL EMERGENCY

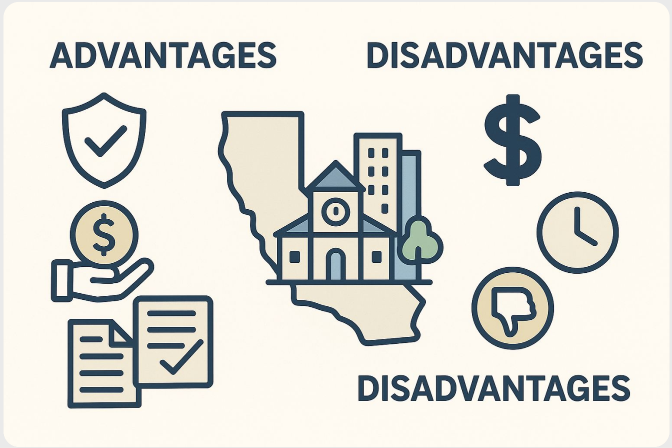
Declared by resolution by a majority vote of the governing body at a noticed public hearing.

Must include findings that:

- the financial condition of City jeopardizes the health, safety, or well-being of the residents absent the protections of Chapter 9
- the City will be unable to pay its financial obligations within the next 60 days (Gov. Code §53760.5)

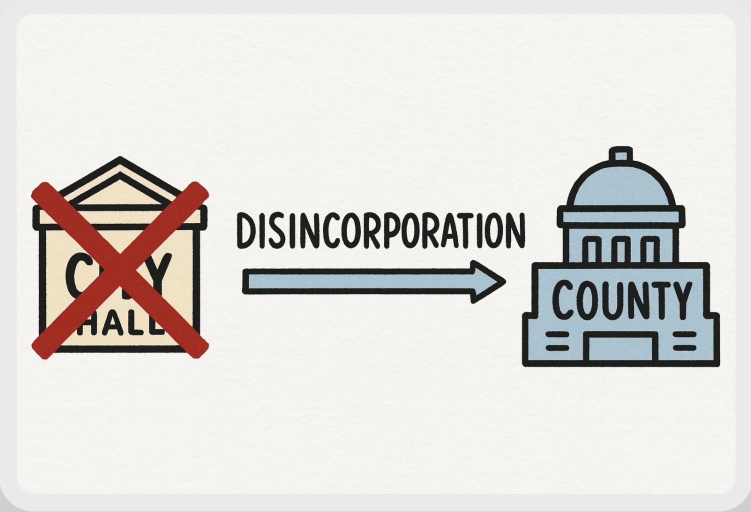
ADVANTAGES AND DISADVANTAGES OF BANKRUPTCY

- Advantages:
  - Relief from creditor action – temporarily halts lawsuits or other creditor actions, allowing the City to stabilize finances and develop a plan of adjustment
  - Adjustment of debt – creditors can be required to accept restructuring that lowers or extends debt obligations
  - Continuance of operations – municipality can continue providing essential public services while bankruptcy is occurring
- Disadvantages:
  - Significant cost $$$ – requires retaining legal and financial professionals to manage the case, negotiate with creditors, and develop a plan of adjustment
  - Staff commitment – substantial staff time and resources must be dedicated
  - Reputational harm – may deter potential business and investment in the City



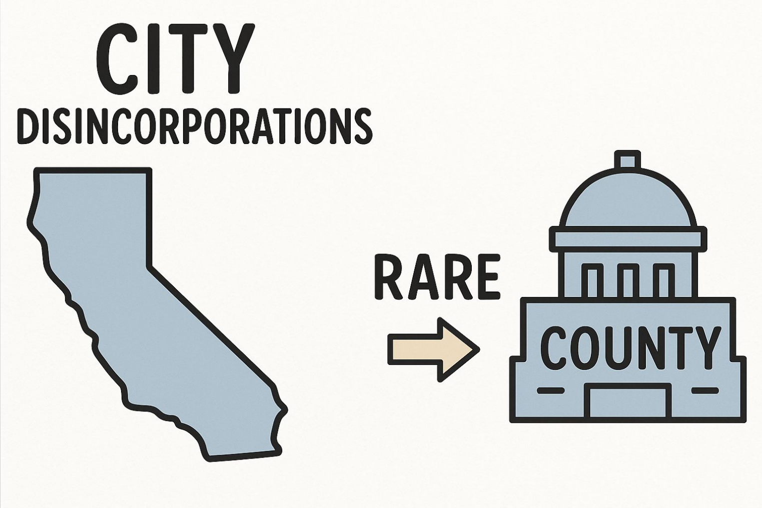
CONSIDERING DISINCORPORATION

- If bankruptcy is determined to be infeasible or not in the best interest of the City, the City may consider disincorporation as an alternative path
- Disincorporation would mean that the City of Isleton would legally cease to exist as a municipal government
  - All governmental powers, services, and responsibilities revert to other government entities, such as the County of Sacramento or special districts



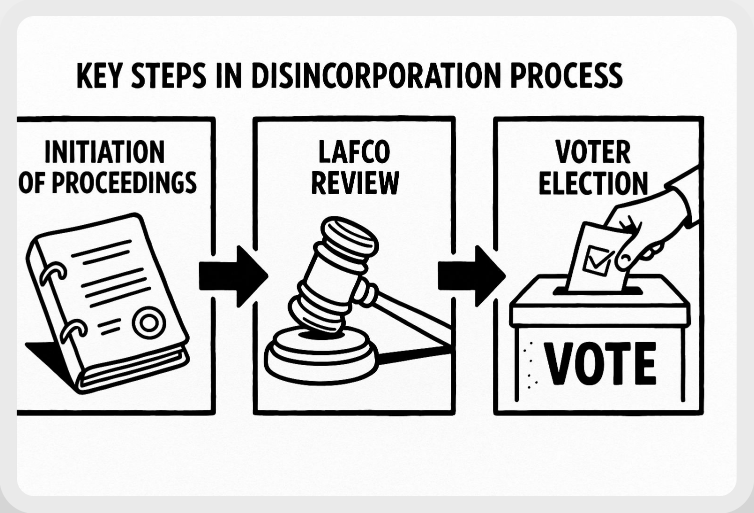
HISTORICAL CONTEXT

- Extremely rare in the modern era – only a few cases in California history
- Last successful disincorporation under the Act was the City of Cabazon (Riverside County) in 1972
    - The City of Hornitos (Mariposa County) disincorporated in 1973 by special legislation
- Occasionally considered as an alternative to bankruptcy but very rarely carried out
- Notable attempts:
    - City of Vallejo – pursued bankruptcy instead (2008)
    - City of Vernon – state legislative attempt vetoed (2011)



DISINCORPORATION PROCESS

- Initiation of Proceedings
  - May be initiated by City Council, voter petition, or LAFCO action
  - Proposal is submitted to LAFCO for review
    - Includes a Comprehensive Fiscal Analysis (CFA) detailing assets, liabilities, revenues, and service costs
- Local Agency Formation Commission (LAFCO) review
  - Analyze fiscal impacts and service transfers
  - Conduct public hearings and consider community input
  - May impose conditions or require coordination with the County or Special Districts
- Voter Election
  - If approved by LAFCO, goes to a vote by Isleton voters



DEBT AND OBLIGATIONS AFTER DISINCORPORATION

- Disincorporation does not dissolve or reduce existing debts
  - Creditors retain the same legal rights as if the City still existed
  - May be enforced against the successor taking on the debt (GC §56121)
- LAFCO may require:
  - Completion of final audits and asset inventory
  - Payment or assumption of debts
  - Establishment of a successor agency or service area for ongoing obligations
- LAFCO is unlikely to approve plan unless successor consents to assume these obligations

AFTER DISINCORPORATION

- Property and Finances
  - All public property would be transferred to the possession and control of the County or special districts designated by LAFCO (GC §57401)
  - All City funds, taxes, and assessments go to the County Treasurer(GC §57403 – 57405)
  - The County Board of Supervisors may assume control of all public utilities owned by the city at the time of disincorporation (GC §57415)
- Land Use and Planning
  - City's General Plan constitutes a "community plan" of the County until the County updates or amends its General Plan. (GC §57426(a))
  - City's zoning continues until the County replace or updates the zoning ordinances (GC §57426(b))
  - Any Conditional Use Permit or legal nonconforming use remains in force, subject to the community plan and zoning ordinances (GC §57426(c))
  - Any use of land authorized by the General Plan and zoning ordinances in effect prior to disincorporation continue for as long as required by the California Constitution or US Constitution (GC §57426(d))

SUMMARY

- <u>Chapter 9 Bankruptcy</u>
  - Allows City to restructure debts under federal court protection while continuing essential services
  - Required to prove insolvency, good faith, and either negotiate with creditors or show impracticable
  - Must conduct neutral evaluation process or declare fiscal emergency
  - Significant monetary cost and reputational harm
- <u>Disincorporation</u>
  - City ceases to exist as legal entity – powers and assets transfer to County or special districts
  - Initiated by City, Voters, or LAFCO
  - Must result in all debts and obligations being paid or assumed
  - Requires comprehensive fiscal analysis, LAFCO review and approval, voter approval
  - Extremely rare