MUNICIPAL INSOLVENCY

Diana DELEANU[*]

Abstract

In the current credit crunch, municipal insolvency is a much needed legal instrument for public administration.

Municipal restructuring offers distressed communities the chance to a fresh start.

Keywords: *municipal insolvency, restructuring, bankruptcy, credit crunch, public administration*

Introduction

Insolvency represents a shortage of funds available for paying liquid and due certain debts. Traditionally, it is private entities which file for commencement of insolvency proceedings.

Given the financial crisis Romania is facing for a few years now and the existing budgetary constraints, there came the need for regulating insolvency proceedings for administrative units.

Municipal insolvency is already common practice in foreign legal systems.

This study focuses on two stages: before and after the moment the nr. 46/2013 Emergency Government's Ordinance was adopted. In the first part of the paper, a project of the bill is analyzed, this being a regulation which paused at the Parliament for a while, after being filed in the spring of 2010 by the Government. The current regulation used part of this project -which nearly came to life- and abruptly appeared in May 2013, managing to leave room for improvement from the beginning.

This paper is meant to show the need for a proper working system and displays a critical comparison of the two bills, none of them being truly viable, as practice proves too well.

While much needed in practice, to relief the ever increasing burden of debts created by ever-so-unperformant authorities, the regulation attempts an unsuccessful adaptation of the anglo-saxon model to the national legislation. Too shy to import all, and too new to know it all, it resembles a beautiful frame which lacks canvas. It just exposes a situation in all its darkness, creates a worrying imperfect mechanism and leaves the local community with just as much money, but much less hope.

Just as the white smoke which rises from Vatican offering persective while trembling believers wait in need for guidance, the Romanian business environment may now say: „habemus legem!"

Content

Under these circumstances, the corporate insolvency regulation governed by Law no. 85/2006 has been adapted to the administrative units which are public entities at their best.

* Lecturer Professor Ph.D. candidate Diana Deleanu, „Nicolae Titulescu" University, Bucharest (dianadel@univnt.ro)

At the moment, it is a worrying fact that some 200 administrative units qualify as insolvent or in financial crisis.

The initiative for this municipal insolvency regulation appeared in art. 74 and 75 of nr. 273/2006 Law.

The huge theoretical challenge is to adapt a private institution to public legal subjects.

The final compromise was that only the restructuring stage of the insolvency proceedings is to be applied for administrative units, given the fact that a state structural unit can not be dissolved without changing the current Constitution, so, the normal consequence of insolvency proceedings'failure is inappliccable here. Therefore the law states measures to overcome the financial crisis and to take the adminisrative unit on the road to recovery.

The need for such special procedures arose because mismanaged administrative units began to represent true „black holes" in the economy, thus disrupting the financial cycle for the private entities they do business with, which ultimatelly generates numerous corporate insolvency cases. One of the main purposes of this procedure is, therefore, protecting third parties (who act in good faith) .

In most cases, insolvency is caused by the untimely performance of financial obligations by public institutions. As a consequence, commercially viable traders, whose activity depends on the business relations with the poorly-managed administrative unit face their own insolvency.

Under these circumstances, the personal liability of the public servant provisions are certainly inspired by nr. 85/2006 Law on the administrator's liability. As a consequence the law regulates the fraudulent actions, as well as the mismanagement of the public entities.

Given the public law characterisics of this position and the fact that it may only be accessed by following the electoral process and not by appointment, no private law proceedings may take away what it has not given. The mayor's mandate is given by the citizens -and based on the legal symetry principle- it can only be removed by the electorate, the same way it was awarded.

In this context, the municipal insolvency proceedings shall influence only on the economic and financial governance side of the head of administrative unit's activity.

Even in the case of the mayor's personal liability, the law only strips them from their financial attributes and not from their various other tasks which the electoral mandate offered.

The purpose of the insolvency proceedings is -in an ideal situation– the full recovery. Only if the recovery proves impossible, nr. 85/2006 law move to more drastic measures (proper liquidation in the bankruptcy stage) .

Such legislation is inconceivably drastic for an administrative unit and the initial bill project suggested the dissolution of the unit whose recovery plan was not successful and its assimilation by the neighbouring performant one.

Territorial restructuring (cnstitutional) issues aside, the implementation of such measures leads to the need to obtain community acceptance from the performant unit.

Such a burdensome decision for the community's economic efficiency could only be made through a referendum. This act of direct democracy and sovereignty of the local community appears as the only solution in a situation that could make the difference between today's economic balance and possible financial failure, generated by the difficulties encountered by joining a bankrupt entity .

The main legal issue is a public law entity being subjected to an essentially private law procedure. The status of administrative unit cannot be in any way altered by the insolvency proceedings.

The purpose of regulation is not only to end the financial crisis and the insolvency status, but also to prevent other similar cases. Because the whole procedure is dominated by

public law, no drastic measures can be taken towards the administrative unit and its leaders, and a law without a sanction is rarely observed.

Some major differences between the corporate and the municipal insolvency proceedings are :

a. the head of the administrative unit is never stripped of their non-financial powers (which are provided by electoral mandate provided, and are not to be withdrawn)

b. the public entity will never be dissolved (as Law nr . 85/2006 states for trade companies) and

c. the public entity's creditors will benefit from a full recovery of the debt, because the source of funding is a budgetary one, so it is stable and constant.

In the matter of liability coverage, the public entity's assets may only be liquidate by – first and foremost- transferring them from the public to the private domain, in order for them to be sold for covering the debt, therefore limiting the insolvency practitioner's access to an easy solution.

In Romania the insolvency proceedings is a public, transparent and competitive process. In other legislations, however, the municipal insolvency is characterized by confidentiality in order to protect the business partners' trust in the entity facing difficulties.

In addition to the clear advantages this procedures has, but there is always the risk of abusing rights. In this case, the head of the administrative units may be tempted to relieve the problem of debt payments towards third parties in a time of economic crisis or just to take advantage of the fact that they may suspend foreclosures, managing to prevent unpopular measures given the fact that their access to such a position is based on trust and the public image voters may have.

The head of the administrative unit's liability is considered only in his capacity as financial decision-maker of the entity, therefore the regulation is almost identical to the liability of directors and other governing bodies of a company (see art . 138 of Law no. 85 / 2006) .

The personal liability is based on the their failure to predict a realistic level of income and expenses.

There is, also, the failure of the Auditors'Court (Curtea de Conturi) to properly control the spending of public money, since an efficient preventive control would almost eliminate the risk of financial crisis and/or insolvency.

Perhaps a cheaper and more effective solution would be to prevent insolvency by improving the public services provided by the Court, associated with a stronger enforcement of the personal liability of the public officials involved.

Another responsible entity, perhaps much closer to the work of the administrative unit is the local County Department of Finance. It is empowered to conduct the financial and tax supervision, along with the judicial review of the documents performed by the Prefect .

In this case, the only question would be to draw a line between the Court's competence and the one of the County Department of Finance's.

The insolvency proceedings will be conducted by the bankruptcy judge, the main actor in this case . The insolvency administrator may be any compatible insolvency practitioner who meets the selection criteria. Their fee will be calculated proportionally with the head of administrative unit's salary, therefore it might be an issue to attract good insolvency specialists in complex cases with a low fee. A solution could be adding a success fee, be it fixed or representing a percentage of the recovered debt, as in the similar regulation of trade procedures.

Given the impossibility to liquidate an administrative unit that has failed even in insolvency proceedings, one of the suggested solutions was at some point to dissolve this unit and add it to a neighbouring administrative subdivision.

Such a measure , however, would require prior modification of both the Constitution and the Law nr. 341/2005 .

Although such a solution could substantially reduce administrative costs, and increase organizational efficiency , it would seriously infringe the sovereignty of the local community and its right to self-manage. In our view, it would be contrary to the core principles of public administration. Basically it is a matter of balance between the principle of local autonomy and the financial and tax management .

Contrary to the opinion expressed above, there are also examples of success : Denmark reducing the number of administrative units from about 1119-90 , the same trend enrolling Poland and Great Britain.

Curent Regulation – Nr. 46/2013 Emergency Government's Ordinance

The institution was first regulated by nr. 46 EGO from May the 21st, 2013 concerning financial crisis and the insolvency of administrative units.

The decision to urgently adopt this regulation was justified by the large amount of debts public entities have, although as at the end of December 2011 oustanding debts in the national economy amounted to about 110 billion, out of which almost 82 billion (i.e. about 80 %) belonged to the private sector . A strong influence was also the stand-by agreement with the International Monetary Fund.

Comparing nr. 46/2013 EGO to nr. 85/2006 Law a few differences arise:

- the EGO does not state a nominal value of the claim (such as Lei 45,000 in another example) but a percentage calculated from the entire budget of the institution.
- the payment period is longer for public entities (120 days) than for companies (90 days)
- the second criterion for assessing the difficuly state of the public entity is somewhat ambiguous, since it does not represent a percentage of the wages, but it seems to consider the total amount of unpaid wages unpaid for more than 120 days .
- also, there is no concept of imminent insolvency situation as governed by nr. 85/2006 law (i.e.: predictable insolvency in the near future).

A local register of municipal insolvency files is to be kept, this being a public document continuously updated on the website which is administered by the Ministry, therefore this qualifies as an example of transparency from the authorities.

Basically recovery may mean mainly rescheduling / hair-cuts / adjusting claims, respecting payment waiver programs concerning essential services, cost reduction, a.s.o.

In case of restructuring plan rejection by the majority, according to art. 100 from nr.46/2013 EGO, the judge shall grant a new deadline for its adopting it. The law does not specify how many times can a plan be voted, so basically , it can be suggested over again until the majority decides to adopt it, since any other measure (such as dissolving the entity is out of the question).

Comparative Law

The Anglo Saxon (U.S.) Model

Municipal insolvency is expressly regulated in Chapter 9 of the " Bankruptcy Code" and there is an old practice for more than three decades, so far being more than 500 requests to commence the procedure involved towns, villages , districts , tax districts ,school districts and municipal utilities.

The purpose of the procedure is to ensure protection for state entities with financial problems.

The creditors attempt to develop and negotiate a plan of debt adjustment by extending the maturity , reducing the main debt or interest or by getting a new refinancing loan.

Obviously, the law does not regulate the dissolution of the administrative unit, such an assumption being inconsistent with the 10th Amendment of the U.S. Constitution . Basically the rescheduling and reduction of the debt is the way to overcome such difficuties.

The city of Detroit found itself last year very close to insolvency and recovering its viability is still a work in progress.

France, the Netherlands and Ukraine do not have such options in their legislation, even though

there could be a need for such provisions for municipalities, departments and regions.

In France, the so-called " toxic loans " contracted by local authorities are estimated at over Euro 18 billion affecting over 4,000 local entities. Currently they cannot file for insolvency and public assets can be brought as warranty. If towns are to become insolvent, the French (social) government intervenes and makes the necessary tax adjustment and facilitates negotiation with the creditors.

Conclusion

The proceedings may very well be successful, but the current legal design does not provide any solution if insolvency proceedings do not take the entity to financial balance.

Finally, the question remains: what happens if the insolvency procedure fails [since there is no other solution (even the questionable one of joining two administrative units)]? Will the proceedings restart? How many times? Was it not the purpose of the insolvency proceedings to bring better health to the economic environment by removing malfunctioning elements to –ultimatelly- protect the credit? Does the rule " survival of the fittest" not apply in this case? (survival of the performant entity and bringing back the debtor's viable assets to the trade circuit)?

The notion of insolvency, bankruptcy, to be more specific, comes from the Italian phrase "banca rotta" meaning the destruction of " platform " on which a trade is carried out inefficiently and / or incorrectly in order to maintain market viability .

Essentially, insolvency is a penalty which acts as a basis for a functioning future economic environment.

References:

In Romanian:

- Apostol Tofan, Dana - " Administrative Law " - All Beck Publishing House , Bucharest - Vol I & Vol II -2008 -2010
- Turcu, Ion , "Insolvency" CH Beck Publishing House , Bucharest , 2007
- Turcu, Ion, " Theoretical and practical handbook of commercial law " CH Beck Publishing House, 2009
- Piperea, Gheorghe " Commercial law" CH Beck Publishing House, Bucharest , 2009
- Avram, Aurica " Insolvency proceedings" Hamangiu Publishing House , 2008
- Piperea, Gheorghe - " Insolvency . Introduction" , published on the website " Juridice.ro ", 2008
- Piperea, Gheorghe - " Insolvency . Scope and purpose of the proceedings " , published on the website " Juridice.ro ", 2008

In English :

- Frederick Tung - " Hastings Law Journal " - "After Orange County : Reforming California Municipal Bankruptcy Law " , USA, 2002
- Eurofenix Magazine - published by INSOL EUROPE

Foreign case law :

- • US municipal insolvency cases (e.g.: 2009 –city of Vallejo, Orange County)

Legislation :

- The Romanian Constitution
- EGO nr. 46/2013
- Law nr. 215/2001
- Law nr. 341/2005
- Law nr. 273/2006
- Law nr. 85/2006
- EGO nr. 63/2010