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What State Receivership Means and Why It's Best to Avoid It

[Editor's Note: It is probably just coincidence, but we have had quite a number of inquiries recently about the consequences of just turning over the keys to the district to the state if the state doesn't stop cutting education. Since the Fiscal Crisis and Management Assistance Team (FCMAT) has responsibility for assisting districts in their efforts to avoid or deal with financial problems, we asked Joel Montero, FCMAT's Chief Executive Officer, to author this article.]

Last spring, California had the highest number of districts ever with qualified or negative certifications on their Second Interim budgets, reflecting the growing number of districts in fiscal distress. When a district gets to the point where it no longer has the cash to pay its bills, it must apply for a state loan, which means state receivership. Unfortunately, as a sign of the times, we have received many questions from districts about what state receivership looks like. What follows is some information on current law and, for a practical matter, what we have seen most recently in the districts that have required a state loan.

Budget Reserves vs. Cash Reserves

A school district receives a qualified or negative certification generally because of its inability to maintain the state-required level of reserves in all three years of its multiyear projections. Running out of reserves by itself, however, does not cause a school district to require a state loan; running out of cash does.

The distinction between reserve levels and cash levels becomes clearer when looking at your General Fund balance sheet. Reserves are the (hopefully positive) difference between assets and liabilities, some of which are cash and some of which are not. On the assets side, there are several cash accounts that are obviously cash—Cash in County Treasury, Cash in Bank, Cash with Fiscal Agent, etc. Not all cash is accessible to pay bills—for example, Cash with Fiscal Agent is set aside for a specific purpose and the district may not have the legal authority to draw on that cash to pay for operations. Other assets are not cash—for example, Stores Inventory and Prepaid Expenses. Most liabilities are not cash, but one notable exception is Deferred Revenues, since this represents cash that has been received by the district. It is set up as a liability because it cannot be recognized as revenue until it has been spent on the specific purpose of the grantor agency.

It has generally held true that low reserve levels are an indicator of low cash levels and vice versa. However, with the recent state cash deferrals, this has become less true. School districts with prudent reserves are still having to manage their cash actively and borrow to get through the negative cash months. And districts with inadequate reserves are having an even tougher time ensuring that the cash is there to meet the obligations when due.

Cash Borrowing Options

There are several options available to a school district to borrow cash locally—from its other funds, using tax and revenue anticipation notes (TRANS), from the county office of education, or from the county treasurer (Education Code Sections [E.C.] 42621, 42620). However, all of these options are temporary, short-term borrowing—they generally require that the district pay back the borrowing within a year or less.

*SYSD was rejected from
TRAN pool in 2012.*

For each of these types of borrowing, the district is required to prepare a cash flow projection that indicates that the borrowing can be paid back from the district's future revenues in the time frame required.

If the cash flow projection, however, shows that the district will be unable to pay back the local borrowing, it means that the cash balance is trending downward with no end in sight—that the future revenues are not enough to keep up with operational obligations plus pay back the borrowing. If the district is unable to borrow locally, then the only other option is to request a loan from the state.

State Loan

A loan (technically referred to in the Education Code as an emergency appropriation) from the state requires that one of the district's local representatives to the State Legislature sponsor a bill through the legislative process. This is typically an urgency bill, meaning that it requires at least a two-thirds vote of each house of the Legislature so that it can become effective upon the Governor's signature. The legislative process takes many months, so a state loan should be initiated early enough to ensure that the cash is there when the district needs it, and the timing needs to work within the legislative calendar. Typically, the bill has to be introduced in January in order to work its way through all of the legislative committees and the floors of both houses by the summer or early fall.

A loan from the state results in the state taking control of the school district. The degree of state control is determined by the size of the loan relative to the district's budget. Specifically, per E.C. 41326(a), if the loan is less than twice the size of the district's required reserve level, a State Trustee is assigned and assumes authority over the financial aspects of the school district's activities. If the size of the loan exceeds twice the size of the district's required reserve level, the following takes place:

- The school Board loses its powers and becomes advisory only [E.C. 41326(c)(1)]
- The Superintendent is no longer employed by the district [E.C. 41326(c)(2)]
- A State Administrator is assigned and assumes the powers of the Board and Superintendent [E.C. 41326(b)]

State loans are typically set up for repayment over 20 years. In both situations above, state control remains over the school district until the loan is fully repaid. The State Trustee or State Administrator reports directly to the Superintendent of Public Instruction—the state of California—not the local school Board or community.

The state loan is sized to accommodate the anticipated shortfall in cash that the district will need during the life of the loan in order to meet its obligations. In addition, all of the costs of ensuring a fiscal recovery are the responsibility of the district (E.C. 41328) and are added to the amount of the state loan. The cost of recovery when a State Administrator is assigned includes:

- The cost of the compensation package for the State Administrator (E.C. 41326[(b)][(8)])
- The cost of additional staffing as determined by the State Administrator to be necessary for ensuring fiscal recovery (E.C. 41326[(b)][(9)])
- The cost of management reviews and developing a recovery plan, including the cost of the initial comprehensive review and follow-up reviews every six months encompassing these five areas of the district (E.C. 41327.1):
 - Community relations and governance
 - Pupil achievement
 - Financial management
 - Personnel management
 - Facilities management
- Any other expenditures deemed necessary by the State Administrator to help ensure fiscal recovery

On the natural, a state loan will be much larger than what the district would otherwise need to borrow locally if it had been able to solve its own fiscal crisis. Therefore, a district that receives a state loan needs to make more expenditure cuts and/or take longer to pay the loan back.

The comprehensive review and six-month follow-up studies measure the district's progress in meeting the standards established. In the areas where the district has progressed enough in meeting the standards, the Board receives its powers back and a Superintendent is hired to administer those areas. It normally takes several years before the Board regains any of its powers. State control remains, either in the form of a State Administrator or State Trustee, with stay or rescind power over certain Board actions until the state loan is paid off.

The State Administrator's mission is to restore fiscal solvency as soon as possible so that the loan can be paid back to the state. This will be done by reducing expenditures to a level that is lower than revenues so that the reserves can be rebuilt over time while the state loan is being paid back. This means that all possible avenues for balancing the budget are pursued. The State Administrator cannot set aside any contractual obligations that the district has already entered into, including vendor contracts and bargaining unit contracts, without renegotiating them. If modifying provisions of these contracts is critical to gaining fiscal solvency, the State Administrator has the power to invoke the timelines available in the contracts or by law, including the ability to use the impasse/factfinding process to unilaterally impose changes in collective bargaining agreements.

Conclusion

A district in financial trouble will regain fiscal solvency. If the district and the Board, while it has the power, do not take the necessary actions locally to restore fiscal solvency, the same actions and more will be imposed by the state. The typical state loan is established to be a 20-year payback. The district remains under some level of state control until that payback is complete. Generally, recovery costs more and takes longer if a state loan is required.

In the long term, taking the necessary actions locally and avoiding a state loan will result in greater local control, less outside intervention, and better long-term outcomes for students, employees, and the community.

—*Joel Montero*

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(2) The administrator shall have recognized expertise in management and finance.

(3) To facilitate the appointment of the administrator and the employment of necessary staff, for purposes of this section, the Superintendent is exempt from the requirements of Article 6 (commencing with Section 999) of Chapter 6 of Division 4 of the Military and Veterans Code and Part 2 (commencing with Section 10100) of Division 2 of the Public Contract Code.

(4) Notwithstanding any other law, the Superintendent may appoint an employee of the state or the office of the county superintendent of schools to act as administrator for up to the duration of the administratorship. During the tenure of his or her appointment, the administrator, if he or she is an employee of the state or the office of the county superintendent of schools, is an employee of the qualifying school district, but shall remain in the same retirement system under the same plan that has been provided by his or her employment with the state or the office of the county superintendent of schools. Upon the expiration or termination of the appointment, the employee shall have the right to return to his or her former position, or to a position at substantially the same level as that position, with the state or the office of the county superintendent of schools. The time served in the appointment shall be counted for all purposes as if the administrator had served that time in his or her former position with the state or the office of the county superintendent of schools.

(5) Except for an individual appointed as an administrator by the Superintendent pursuant to paragraph (4), the administrator shall be a member of the State Teachers' Retirement System, if qualified, for the period of service as administrator, unless he or she elects in writing not to become a member. A person who is a member or retirant of the State Teachers' Retirement System at the time of appointment shall continue to be a member or retirant of the system for the duration of the appointment. If the administrator chooses to become a member or is already a member, the administrator shall be placed on the payroll of the qualifying school district for purposes of providing appropriate contributions to the system. The Superintendent may also require the administrator to be placed on the payroll of the qualifying school district for purposes of remuneration, other benefits, and payroll deductions.

(6) For purposes of workers' compensation benefits, the administrator is an employee of the qualifying school district, except that an administrator appointed pursuant to paragraph (4) may be deemed an employee of the state or office of the county superintendent of schools, as applicable.

(7) The qualifying school district shall add the administrator as a covered employee of the qualifying school district for all purposes of errors and omissions liability insurance policies.

(8) The salary and benefits of the administrator shall be established by the Superintendent and paid by the qualifying school district.

(9) The Superintendent or the administrator may employ, on a short-term basis and at the expense of the qualifying school district, any staff necessary to assist the administrator, including, but not limited to, a certified public accountant.

(10) The administrator may do all of the following:

(A) Implement substantial changes in the fiscal policies and practices of the qualifying school district, including, if necessary, the filing of a petition under Chapter 9 (commencing with Section 901) of Title 11 of the United States Code for the adjustment of indebtedness.

after January 1, 1992, if the employee fails to document, to the satisfaction of the administrator, that before the date of the acceptance of the emergency apportionment he or she either advised the governing board of the qualifying school district, or his or her superior, that actions contemplated or taken by the governing board of the qualifying school district could result in the fiscal insolvency of the qualifying school district, or took other appropriate action to avert that fiscal insolvency.

(e) The authority of the Superintendent, and the administrator, under this section shall continue until all of the following occur:

(1) (A) After one complete fiscal year has elapsed following the qualifying school district's acceptance of an emergency apportionment as described in subdivision (a), the administrator determines, and so notifies the Superintendent and the county superintendent of schools, that future compliance by the qualifying school district with the recovery plans approved pursuant to paragraph (2) is probable.

(B) The Superintendent may return power to the governing board of the qualifying school district for an area listed in subdivision (a) of Section 41327.1 if performance under the recovery plan for that area has been demonstrated to the satisfaction of the Superintendent.

(2) The Superintendent has approved all of the recovery plans referred to in subdivision (a) of Section 41327 and the County Office Fiscal Crisis and Management Assistance Team completes the improvement plans specified in Section 41327.1 and has completed a minimum of two reports identifying the qualifying school district's progress in implementing the improvement plans.

(3) The administrator certifies that all necessary collective bargaining agreements have been negotiated and ratified, and that the agreements are consistent with the terms of the recovery plans.

(4) The qualifying school district has completed all reports required by the Superintendent and the administrator.

(5) The Superintendent determines that future compliance by the qualifying school district with the recovery plans approved pursuant to paragraph (2) is probable.

(f) When the conditions stated in subdivision (e) have been met, and at least 60 days after the Superintendent has notified the Legislature, the Department of Finance, the Controller, and the county superintendent of schools that he or she expects the conditions prescribed pursuant to this section to be met, the governing board of the qualifying school district shall regain all of its legal rights, duties, and powers, except for the powers held by the trustee provided for pursuant to Article 2 (commencing with Section 41320). The Superintendent shall appoint a trustee under Section 41320.1 to monitor and review the operations of the qualifying school district until the conditions of subdivision (b) of that section have been met.

(g) Notwithstanding subdivision (f), if the qualifying school district violates a provision of the recovery plans approved by the Superintendent pursuant to this article within five years after the trustee appointed pursuant to Section 41320.1 is removed or after the emergency apportionment is repaid, whichever occurs later, or the improvement plans specified in Section 41327.1 during the period of the trustee's appointment, the Superintendent may reassume, either directly or through an administrator appointed in accordance with this section, all of the legal rights, duties, and powers of the governing board of the qualifying school district. The Superintendent shall return to the governing board of the qualifying school district all of its legal rights, duties, and powers reassumed under this subdivision when he or she determines that future compliance

with the approved recovery plans is probable, or after a period of one year, whichever occurs later.

(h) Article 2 (commencing with Section 41320) shall apply except as otherwise specified in this article.

(i) It is the intent of the Legislature that the legislative budget subcommittees annually conduct a review of each qualifying school district that includes an evaluation of the financial condition of the qualifying school district, the impact of the recovery plans upon the qualifying school district's educational program, and the efforts made by the state-appointed administrator to obtain input from the community and the governing board of the qualifying school district.

(j) (1) The district superintendent is entitled to a due process hearing for purposes of determining final compensation. The final compensation of the district superintendent shall be between zero and six times his or her monthly salary. The outcome of the due process hearing shall be reported to the Superintendent and the public. The information provided to the public shall explain the rationale for the compensation.

(2) This subdivision applies only to a contract for employment negotiated on or after June 21, 2004.

(k) (1) When the Superintendent assumes control over a school district pursuant to subdivision (b), he or she shall, in consultation with the County Office Fiscal Crisis and Management Assistance Team, review the fiscal oversight of the qualifying school district by the county superintendent of schools. The Superintendent may consult with other fiscal experts, including other county superintendents of schools and regional fiscal teams, in conducting this review.

(2) Within three months of assuming control over a qualifying school district, the Superintendent shall report his or her findings to the Legislature and shall provide a copy of that report to the Department of Finance. This report shall include findings as to fiscal oversight actions that were or were not taken and may include recommendations as to an appropriate legislative response to improve fiscal oversight.

(3) If, after performing the duties described in paragraphs (1) and (2), the Superintendent determines that the county superintendent of schools failed to carry out his or her responsibilities for fiscal oversight as required by this code, the Superintendent may exercise the authority of the county superintendent of schools who has oversight responsibilities for a qualifying school district. If the Superintendent finds, based on the report required in paragraph (2), that the county superintendent of schools failed to appropriately take into account particular types of indicators of financial distress, or failed to take appropriate remedial actions in the qualifying school district, the Superintendent shall further investigate whether the county superintendent of schools failed to take into account those indicators, or similarly failed to take appropriate actions in other school districts with negative or qualified certifications, and shall provide an additional report on the fiscal oversight practices of the county superintendent of schools to the appropriate policy and fiscal committees of each house of the Legislature and the Department of Finance.

41326.1. Within 30 days of assuming authority, an administrator who has control over a school district pursuant to Section 41326 shall discuss options for resolving the fiscal problems of the district

conduct a good educational program and fiscal and management practices that shall be used as the basis of evaluating the improvement of qualifying districts pursuant to this article. These standards shall, at a minimum, address all of the following areas:

- (1) Financial management.
- (2) Pupil achievement.
- (3) Personnel management.
- (4) Facilities management.
- (5) Community relations.

(b) If an administrator is appointed pursuant to Section 41326, the County Office Fiscal Crisis and Management Assistance Team established pursuant to Section 42127.8 shall conduct comprehensive assessments in the five areas specified in subdivision (a).

(c) After the assessments specified in subdivision (b) are completed, the Superintendent, in consultation with the County Office Fiscal Crisis and Management Assistance Team and the county superintendent of schools, shall determine, based upon the district's particular needs and circumstances, the level of improvement needed in the standards adopted pursuant to subdivision (a) before local authority will be returned pursuant to subdivision (f) of Section 41326. Based upon this determination, the County Office Fiscal Crisis and Management Assistance Team shall complete improvement plans in the five areas specified in subdivision (a) that focus on the agreed upon standards, and that are consistent with the financial improvement plan.

(d) Beginning six months after an emergency loan is approved, and every six months thereafter until local authority is returned pursuant to subdivision (f) of Section 41326, the County Office Fiscal Crisis and Management Assistance Team shall file a written status report with the appropriate fiscal and policy committees of the Legislature, the Members of the Legislature that represent the qualifying district, any advisory council of the school district, the Superintendent, the county superintendent of schools, and the Director of Finance. The reports shall indicate the progress that the district is making in meeting the recommendations of the improvement plans developed pursuant to this section.

(e) If the County Office Fiscal Crisis and Management Assistance Team indicates in writing that it has insufficient resources to complete the comprehensive assessments, improvement plans, and progress reports required pursuant to this section, the department shall request proposals to complete these tasks, and subject to the approval of the Department of Finance, select an entity to complete the tasks assigned to the County Office Fiscal Crisis and Management Assistance Team pursuant to this section.

41327.2. (a) The appointment of an administrator pursuant to Section 41326 does not remove any statutory rights, duties, or obligations from the county superintendent of schools. The county superintendent of schools retains the responsibility to superintend school districts under his or her jurisdiction.

(b) The county superintendent of schools shall submit reports to the Superintendent, the appropriate fiscal and policy committees of the Legislature, and the Director of Finance subsequent to review by the county superintendent of schools of the district's budget and interim reports in accordance with subdivisions (d) and (g) of, and paragraph (3) of subdivision (i) of, Section 42127, and paragraph (2) of subdivision (a) of, and subdivision (e) of, Section 42131. These reports shall document the fiscal and administrative status of the

qualifying district, particularly in regard to the implementation of fiscal and management recovery plans. Each report shall also include a determination of whether the revenue streams to the district appear to be consistent with its expenditure plan, according to the most recent data available at the time of the report. These reports are required until six months after all rights, duties, and powers are returned to the school district pursuant to this article.

41328. The qualifying district shall bear 100 percent of all costs associated with implementing this article, including the activities of the County Office Fiscal Crisis and Management Assistance Team or the regional team. The Superintendent of Public Instruction shall withhold from the apportionments to be made from the State School Fund to the district the amounts due pursuant to this section.
