

## LEGAL ASPECTS REGARDING THE INSOLVENCY OF ADMINISTRATIVE UNITS

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**Abstract:** *The insolvency of municipalities can be a real solution to their debt problem. The procedure is similar to that applied to commercial companies, but there are important differences, such as for example that public entities cannot go bankrupt. Legal regulations must take into account the specific situation of these institutions, which cannot be dissolved.*

**Keywords:** *insolvency, arrears, local debt, municipality*

### 1. INTRODUCTION

At least 90 cities, towns and villages of Romania, more than half are in the North - East of the country (especially in Vaslui, Botosani, Bacau, Iasi and Neamt), does not even cover 25% of administrative costs, but that does not prevent them from making expenditures that exceed a thousand times the income they are able to collect, preferring to exert pressure continuously on County Councils and the Government to get money through other channels (IPP, 2013).

The government is trying to put stop wastage of public administration for instituting insolvency procedures to administrative territorial units which they not worry about any arrears or loans, because of the central authorities pumped money whenever it reaches a limit situation (Anghel, 2013).

From now on they will have to support the consequences - to default and sell the assets to cover the debt - after approval by the Government (at the IMF request) of an ordinance for insolvency of municipalities.

Discussions on insolvency regulation of municipalities have started in the 2000s, and in 2010 there was even a bill approved by the Government, but it was blocked in Parliament and it was never applied. The large volume of arrears made by local authorities and IMF pressure revived the adoption of a law on municipalities insolvency.

Almost every year the governments have approved amounts of the order of hundreds of millions or even billion lei (about 1.5 billion last year alone) to cover the debts of local communities, but the results are zero, because other and other liabilities are made annually - for example local arrears (debts of more than 90 days) increased from 800 million in December 2012 to 1.2 billion lei at the end of January.

**Table no.1 The evolution of local arrears period 2000-2012**

	200	200	200	200	200	200	200	200	200	200	2009	2010	2011	2012
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	0	1	2	3	4	5	6	7	8				
Local public debt	3.3	41	73	228	872	2200	3472	6174	8238	10836	11940	12800	13800

Source: Public Finance Minister

The revenues of local governments have soared in the past 10 years, from 6.2 billion in 2000 to 44.8 billion lei (over 10 billion Euros) in 2011, as well as debts increased. If in 2000 they were close to zero, are now 13, 8 billion lei (3.2 billion Euros). This means that 30% of the cumulative annual local authorities are loans, but local communities say they do not worry as these as long-term debt. However, during the European debt crisis devastated the local authorities - the most notorious being the case of Spain, while France does not know how toxic loans to cover at least 17 billion Euros of local communities.

Local authorities will continue to collect taxes, but operating expenses may be incurred in excess of the payment possibilities for municipalities, given that there is a controlling factor of these charges by law.

With the advent of a insolvency law on municipalities there will be the mechanism for identification of financial crisis in time. Local government will always exist, but the question is how these budgets are spent: with reason or without. The insolvency law will not answer the question where the money went, but will be a "benchmark" for stopping the wastage (Anghel, 2013).

Municipalities and county councils, whose financing needs have been constantly increasing, they resorted to the issuance of municipal bonds as an alternative to bank loans to finance various projects such as rehabilitation of roads. Until the financial crisis, the municipal bond market experienced a rapid development. In the last three years, only four municipal bonds have reached on BSE. Currently, they are traded on BSE, 37 municipal bonds with an aggregate value of approximately one billion lei.

The municipal bonds are secured by assets of municipalities. But, investing in such securities are not spared from the adverse effects of the financial crisis: higher interest rates, depreciation of the national currency, the issuer default entry. Small municipalities are more likely to enter into default. In the fall of 2009, Oravița municipality was the first case where a local authority has not paid timely interest on a loan bonds (bonds), firing a warning to investors. Less than half a year in 2010, the city of Aninoasa, Hunedoara county, arrived in default and treasury accounts blocked because of debts to the banks and utilities over 30 million lei.

## 2. LEGAL FRAMEWORK OF ROMANIAN INSOLVENCY FOR MUNICIPALITIES

For the first time, municipalities and county councils who do not pay their debts becomes insolvent. Government approved an ordinance 46/24.05.2013 replacing the non-paying mayors with judicial administrators. If they are insolvent and do not notifies this situation, the mayors face the risk to enter into jail.

The government warns the mayors and heads of local and county councils, which could lose their right to make any expense to the detriment of a trustee, if they have remaining debts. About an insolvency law governing the local authorities there are consultations for many years, since arrears "from territory" - the firm arrears over 90 days (always missed a target in the agreement with the IMF) - have led to bottlenecks in the economy, after the principle: the firms do work or provide a good or service to local authorities and the state forget to pay. And arrears are: at the end of 2012, local authorities recorded against suppliers of goods, services and works a volume of arrears of 840 million lei, and in January it was 1.2 billion lei. IMF demanded that the debts be paid quickly if Romania wants to have an agreement with the international institution.

The solution found by the government so far has been to take the masked problem at central and local authorities to provide loans to low-interest through Treasury (the central bank reference rate at 5.25%) in ceilings that have all stepped up to reached 800 million lei. The money left from the central budget to the municipalities have reduced the debt to 750 million lei at the end of April. For mayors and local councils, the payment of arrears from its own resources means giving up investment plans and other expenses, so prefer to wait an outstretched hand from the government, often by increasing state budget funds.

Finally, the government approved an emergency ordinance, a project by Boc government in Parliament in 2010 and stuck in the Legislature, replacing the words "this law" to "this ordinance".

According to Government Emergency Ordinance 46/24.05.2013 approved, when the local authority has the obligation to pay overdue more than 90 days, which exceed 15% of the general budget, it must declare a state of financial crisis.

Within 5 days, it is the Committee for the financial crisis, by order of the prefect, which includes:

- Mayor or chairman of the county council, the territorial administrative unit or subdivision, in financial crisis;
- Head of accounting department, the head of the public service that generated local state of financial crisis;
- A representative of the deliberative local unit
- A representative of the General Directorate of Public Finance.

Within 30 days, the Committee shall prepare a financial recovery plan, endorsed by the Court of Auditors of the territory, which should show how to increase revenues and reduce costs. The authorizing officer needs the opinion of any extra expense or credit contracted.

The situation of financial crisis ends when either the problems have been resolved and no longer notice other for 120 days or administrative unit becomes insolvent.

Mayors and heads of county councils are obliged to ask the court to declare insolvency if the local authority has unpaid debts older than 120 days and above 50% of the general budget or have not paid salaries for more than 120 days.

Within 15 days of the declaration of insolvency, the authorizing officer is obliged to request the opening of insolvency proceedings. If this period exceeds 6 months, then

he is guilty of simple bankruptcy, which is punishable by imprisonment from 3 months to one year or a fine.

After the bankruptcy judge finds the local authority insolvent, a judicial administrator is appointed, which basically lead local authority finances insolvent. Within 30 days, after the administrator gains access to documents of the local authority that can be seen all expenses incurred by the former mayors, the administrator shall report on the causes of insolvency, indicating the persons responsible for this condition. If those responsible for the insolvency tries to hide, steal or destroy documents, they shall be liable to imprisonment from 6 months to 5 years, for the crime of fraudulent bankruptcy. Fraudulent management, both administrator and officer (mayor or chairman of the board) are liable to 5 to 12 years in prison. Moreover, those who have contributed to the entrance of the administrative-territorial unit in insolvency may be constrained by the bankruptcy judge, at the request of the administrator, to pay the debt.

Also within 30 days, the administrator proposed a recovery plan with the main creditor, with the General Directorate of Public Finance District /Public Finances General Directorate of Bucharest and Territorial Chamber of Accounts, after approval of the final table receivables - which prepares all the administrator. According to art. 39, they may initiate action to cancel a fraudulent acts by the credit contracts in the last 120 days before the opening of insolvency proceedings and give opinion to make layoffs, according to the recovery plan. The receiver has the right to have accelerated payment to certain creditors over others. But if Mayors / Heads of councils have made preferential payments to certain creditors than 120 days before the declaration of insolvency, they have to come up with money from home.

With the agreement of the syndic judge, the judicial administrator may request suspension of main duties of the local authority officer and take him this task. Basically, he will take control of finances, and the mayor or chief of county council has not longer decide over money (art.42 in the case when judicial administrator becomes the principal financial authority, it takes over activities affecting the financial situation and / or the specialized property of the mayor or county council and public institutions or local or county, as appropriate, and shall exercise the powers conferred by law temporarily mayor or county council president, in the name and on his behalf, within the powers laid by the bankruptcy judge").

How insolvency procedure can take up to three years, according to the law, some mayors may have the misfortune was not able to perform their duties only for a very reduced mandate.

The local authorities in insolvency must balance the budget and pay debts to creditors. But the holes are not always covered after being cut investment costs and some staff is fired. Difficult task to reduce costs can be sweetened with a simple solution to increase taxes.

The judicial administrator has the right to propose to the deliberative authority (local council, county) the establishing of local taxes / new special taxes, recording the law, to finish the situation of insolvency. Thus, taxpayers could be forced to spend more money out of pocket to cover the financial holes caused by mismanagement of mayors and chiefs of county councils.

Insolvency proceedings cannot last more than three years, during which local authorities should pay creditors amounts due. Insolvent debtor is protected from enforcement action and accumulating interest and penalties on invoices and credits. But that does not mean its assets remains untouched.

If in this term, the liabilities are not covered 100%, the judicial administrator must ensure that "all private property of the local government unit are not required to provide essential public services were sold, leased, rented, liquidated and services and related activities, other than those defined as essential public services have been destroyed / system to help meet the demands of creditors "under Article 97. Among the assets that can be liquidated include land and various buildings.

If for a firm, the unsuccessful outcome of insolvency proceedings is often the bankruptcy, the local authorities cannot be eliminated through bankruptcy. Thus, if in three years they have not paid all the debts and creditors have agreed to reduce their claims, the administrative territorial unit falls back into a state of financial crisis.

Essential services are the public services without the administrative-territorial unit cannot function, established by Government decision within 75 days from the date of entry into force of this emergency ordinance. Most likely, however, including essential public services include the collection of taxes, police, local funded hospitals, schools, issuing permits, transportation and sanitation.

Article 105 brings sad news for service providers by local insolvent authorities, which could not receive the money for up to three years for their work. Any provider of electricity, gas, water, telecommunications, and other similar services shall not be entitled during the application of insolvency proceedings under this ordinance, to change, to refuse or temporarily discontinue such service to the administrative-territorial or public institutions and local or county, as appropriate, irrespective of funding.

Any creditor or group of creditors who have one or more debts, liquid and payable against municipalities, with an aggregate value exceeding 50% of its budget over a period of 120 consecutive days, may petition the court in whose jurisdiction the administrative-territorial unit is located, with a request to open insolvency proceedings against the municipality.

Thus, a municipality or a city council / county / Bucharest may enter into insolvency at the solicitude of creditors unless they demands the most of the claims or ally to request the insolvency. Given that the local authority is obliged to seek insolvency under the same conditions, this law is a difficult instrument used by lenders to compel municipalities to pay outstanding debts. Otherwise, creditors have some rights in insolvency encountered and if the relationship between the companies. Creditors' meeting is convened by those who have at least 30% of the total claims, the composition may also take decisions and actions can challenge the judicial administrator.

### **3. CASE STUDIES: ROMANIA (ANINOASA) VERSUS USA (STOCKTON)**

*Aninoasa* is a city in Hunedoara County, Transylvania, Romania. It has a population of 5,106 inhabitants, is a town from 1989. The main occupation in this city for

300 years was mining, but the late 90's all the mines were closed, now no longer having any mining town and hence no stable source of income for its residents.

Anina Hall, from the Jiu Valley, submitted to the Hunedoara Court a request for declaration of insolvency due to debts that exceed the local budget.

Indebtedness of the City Aninoasa approaching 150%. The amount of debt, including bank loans, rose to 5.7 million lei, while the local budget for this year was set at 4.2 million lei. The highest duty of Aninoasa Hall is the Romanian Commercial Bank, where the amount to be refunded shall be 3.5 million. Already utilities companies have shut-off valve to water and do not have long to cut the light.

Moreover, local authorities have submitted to the Court of Hunedoara in the next ten days, several documents to be presented their request for a declaration of insolvency.

If the court decides that Aninoasa Hall to be declared insolvent when the municipality will pay the current debts, but penalties will be stopped. Only daily penalties that have to pay the BCR rises to 1,500 lei. Also, utility companies will no longer disconnect the headquarters of the various services, such as water, energy and communications. Aninoasa school will not suffer because of insolvency as it has a separate budget. Aninoasa Hall will be able to recover financially in the next three years, if not will have to pay penalties.

After years of negotiations with creditors and ruthless budget cuts that have led to one of the highest crime rates in the United States, the city of **Stockton**, California, went bankrupt. With nearly 300,000 at the 2010 census, Stockton is the largest city in the U.S. became insolvent, and local government debt restructuring could contain invaluable lessons for Detroit metropolis, which is in a serious financial crisis and also on the verge of bankruptcy.

The evolution of Stockton case is followed closely because it will answer a few questions of constitutional law that gives headaches to the lawyers and accountants alike: who has priority for debt recovery - pension funds, as required by California state law, or the bondholders and creditors under federal law? Federal judge upheld municipal bankruptcy Stockton highlighted this dilemma: „I do not know if pensions too high can be brought under control. There are very complex issues and difficult as we anticipate the horizon".

Local Government Association of Stockton creditor believes that the city has not exhausted all available options of negotiation and mediation debt holders before seeking bankruptcy protection, as required by law. The lenders have acted in bad faith during negotiations required before bankruptcy and refused to pay them back party of the costs of mediation.

Stockton Hall tried to restructure some of the debt by reducing government employees, renegotiating labor contracts and social insurance decreased allocations of public officials. Funding for public libraries and recreational areas was halved, and the police only respond to emergencies in progress. The crime rate is among the highest in the U.S.. Funds for emergency services such as firefighters, were also reduced, along with other cuts included in a budget crisis.

Municipalities cannot liquidate assets so that bankruptcy involves a plan to convince creditors to forgive part of the debt. Stockton has debts of \$ 900 million from

CalPERS (California Public Employees Retirement System) pension fund budgetary largest U.S. state, which is, by far, the largest debt of the city. The municipality has borrowed in 2007 to make payments to the pension fund after the recession has reduced tax revenues. It is unclear whether pensions promised to employees in its heyday can be honored. Many California cities are found in a similar situation to CalPERS.

Besides Stockton, six other cities in California have requested bankruptcy protection in the past nine months, also with astronomical debt to the pension fund. Stockton file is likely to reach the Supreme Court and will set an important precedent in relation to government - creditors - pension funds.

#### **4. CONCLUSIONS**

Approving the Emergency Ordinance 46/24.05.2013 regarding "insolvency administrative units" (cities, municipalities and counties), giving rise to new legal situation very interesting theoretically, but practically it is not known how many locations are in a position to enter into bankruptcy throughout the country.

The new law says that if localities insolvent debts older than 120 days, representing over 50% of the general budget or obligations have not been paid wages. Large towns, there is no question of entering into insolvency, but this law will temper the mayors who starts big projects without having the money in the budget and remain at the end of the debts. In contrast, for low income municipalities, insolvency proceedings can easily result if not timely receive money from the government, i.e. localities where they can not cover their own local budget amounts can be up to 80% of the general budget.

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