

Insights and Commentary from Dentons

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Case Study: Jefferson County

Law360, New York (January 23, 2012, 2:30 PM ET) -- Bankruptcy Judge Thomas Bennett began the New Year with a bang — issuing a 57-page decision in the Chapter 9 case of Jefferson County, Ala. This ruling may prove to be one of the most important decisions of the year in one of the "hottest" anticipated areas of bankruptcy law: distressed municipalities.

Pending before the court was a request by a state court-appointed receiver to recover oversight of the county's sewer system granted to him prepetition, as well as money collected from the system to pay down approximately \$3.2 billion of special warrant debt (or approximately 75 percent of the county's total debt). The Jan. 6, 2012, decision may be described as a "split decision" for the parties, with twists.

In a "victory" for the county, the court ruled that the bankruptcy filing divested the receiver of his right to operate the sewer system, thus placing control over the sewer system with the county. For the special revenue warrant holders, the court ruled that the automatic stay does not apply to pledged special revenues, permitting the holders of special revenue warrants to receive payments during the case. However, neither "win" was absolute.

The court noted that the warrant holders could seek relief from the automatic stay to obtain control of the system if facts develop to support such relief. The court also held that special revenues, while not subject to the automatic stay, are subject to priority for "necessary operating expenses" of the system, which the court remanded to the parties in the first instance.

Chapter 9 In General

Chapter 9 of the Bankruptcy Code applies to reorganizations by municipalities and other subdivisions of state government. Chapter 9 was codified as part of the Bankruptcy Code in 1978, although it is based on similar provisions in the Bankruptcy Act dating to the 1930s.

Only certain states have authorized Chapter 9 filings and certain of those states require consent (like the consent of the governor) or satisfaction of other state law preconditions before a Chapter 9 can be validly filed. Even for those states that have broadly authorized Chapter 9 filings in the discretion of the local governmental unit, one of the first steps in a Chapter 9 case is to determine whether the municipality meets the eligibility criteria within Chapter 9 itself.

Jefferson County's Situation

Jefferson County's insolvency stems from debt issued to finance the construction and repair of the county's sewer system. The county entered bankruptcy with a debt load in excess of \$4 billion, approximately \$3.2 billion of which was sewer system debt. The sewer system was financed through special revenue warrants, whose sole source of repayment is revenues generated by the sewer system and which are not secured by the actual sewer system assets themselves.

Between 1997 and 2003, the county issued special revenue warrants backed by the sewer system revenues in an aggregate principal amount of approximately \$3.7 billion. As the court points out, this type of financing is attractive to municipalities for several reasons. First in many states, as in Alabama, special revenue warrants do not require voter approval, whereas bonds' do. Second, special revenue warrants often do not count toward the debt limits imposed by states on municipalities. And, third, many states, Alabama included, do not allow or significantly limit municipalities encumbering property.

By February of 2008, due to a combination of mismanagement, alleged fraud, corruption, and market failures, the county was in default under the warrants and the relevant indenture. After a period of negotiation and forbearance, in September of 2008, the Indenture Trustee and others filed suit in the Northern District of Alabama against the county and its then commissioners seeking, inter alia, to have a receiver appointed.

The court determined that there was sufficient cause to appoint a receiver, but abstained because the Johnson Act, 28 U.S.C. § 1342 proscribes federal appointment of a receiver with rate setting authority. The abstention order was entered in June of 2009, no ruling was made with respect to the remainder of requested relief and the case has been administratively closed.

In August of 2009, the Indenture Trustee filed suit in Alabama state court, again seeking, inter alia, the appointment of a receiver. In September of 2010, the state court granted partial summary judgment in favor of the Indenture Trustee, appointing John S. Young Jr. LLC as receiver (the "Receiver") for the sewer system and entering judgment against the county for approximately \$500 million, which was to be paid only from revenues permitted under the terms of the indenture.

After being appointed, the Receiver took over operation of the sewer system and also facilitated negotiations between the county, the Indenture Trustee, and other parties in interest. Those negotiations resulted in a term sheet that would have precipitated a settlement and reduced the county's sewer debt to approximately \$2.2 billion. Ultimately, however, negotiations failed. On Nov. 9, 2011, the county filed a voluntary petition for relief under Chapter 9 of the Bankruptcy Code.

Bankruptcy Court Ruling

The court began its analysis of the motions by examining the nature of the interest held by a receiver in property under its supervision and concluded that, under applicable law, a receiver has no interest in properties held other than control and possession on behalf of the appointing court. Nor does the appointing court hold an interest in the properties other than holding them in custodia legis.

The court reasoned that because the county maintained legal title and ownership of the sewer system, 28 U.S.C. § 1334(e)(1) gave the court exclusive jurisdiction over those interests, thereby divesting the state court of jurisdiction over the sewer system itself. The court further reasoned that that automatic stay provisions of sections 362(a) and 922(a) of the Bankruptcy Code stayed any actions by the Receiver affecting the county's rights to the sewer system.

Consequently, Chapter 9's omission of the turnover provision of section 543 of the Bankruptcy Code did not serve to exempt the receivership from the stay. The court further held that neither the Indenture Trustee nor the Receiver were governmental units and because the initiation of the county's bankruptcy case divested the state court of jurisdiction, section 362(b)(4) of the Bankruptcy Code, which exempts from the automatic stay certain governmental actions, was inapplicable.

The court next addressed the effect of section 922(d) of the Bankruptcy Code, which exempts from the automatic stay application of "pledged special revenues" to debt secured thereby. The county argued that the term "pledged" in this context only refers to special revenues in possession of the Indenture Trustee at the commencement of the case.

After an extensive review of the word "pledge" in common usage as well as various legal contexts and a review of the legislative history regarding section 922(d), the court concluded that section 922(d) refers both to those pledged funds in possession of the creditor as well as the entire future revenue stream of payments.

The court found further support for this argument in excerpts of the legislative history of the 1988 amendments to the Bankruptcy Code that sections 928 and 922(d) were intended to preserve creditors' liens on municipal special revenues that might otherwise be avoided through the operation of section 522(a) of the Bankruptcy Code. The court did acknowledge, however, that under section 928(b) liens on special revenues are subordinate to "necessary operating expenses" of the assets from which they are derived.

Finally, the court found that no grounds existed for either mandatory or discretionary abstention nor did they exist for stay modification. The fact that a new set of county commissioners had been elected and that the commissioners involved in the alleged mismanagement, fraud and corruption were no longer in place was a factor in the court's reasoning. The court did not, however, foreclose the possibility for renewed abstention or stay-modification requests in the future if appropriate circumstances existed.

Impact

This opinion is significant to holders of municipal special revenue financing because it confirms creditors' rights to continue to receive the pledged revenue streams after a municipal bankruptcy filing, subject only to deductions for necessary operating expenses. Had the court adopted the county's interpretation of section 928 of the Bankruptcy Code, special revenue warrant holders could have been deprived of the ability to continue to receive future pledged revenues without seeking leave from a bankruptcy court.

Otherwise, the court generally did not defer in favor of the state court receivership. In particular, the court retained exclusive jurisdiction over the assets themselves and the county and its commissioners will have the lead on addressing going forward sewer fee and rate increases going forward (which may be less than the Receiver and Indenture Trustee had planned on) and other material decisions regarding operation and administration of the sewer system.

It should be noted that the court did not find it necessary at this stage to determine the county's eligibility to be a debtor under Chapter 9, which may be the next significant battle in the Jefferson County case. The Indenture Trustee and certain other creditors have asked that the Bankruptcy Court certify certain questions of Alabama law to the Alabama Supreme Court related to whether the county is eligible to file Chapter 9 under Alabama's arguably limited Chapter 9 authorization statute.

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