

**Memorandum**

**May 2, 2012**

**To: Bond Dealers of America**

**Subject: Summary Report on Jefferson County, AL, Chapter 9 Proceedings**

By now the story of how Jefferson County, Alabama (“JeffCo”), ended up being the largest chapter 9 bankruptcy proceeding ever has become familiar. In 1996, a Consent Decree was entered against JeffCo in a federal court case initiated under the Clean Water Act. The Consent Decree required that JeffCo undertake to improve the way it managed the County’s sewer system so as to improve the health of JeffCo’s rivers and streams. In pursuit of that goal, JeffCo acquired existing but outdated and poorly maintained sewer systems from its various cities and towns and undertook to rehabilitate and extend those systems issuing warrants to cover the costs as the project went along. JeffCo financed its sewer system acquisition and construction with various types of warrants including auction rate, variable rate and fixed rate while also entering into a number of related interest rates swaps. The non-recourse warrants were secured by a net pledge of sewer system revenues. The indenture contained a rate covenant that required JeffCo to implement rate increases necessary to maintain payments on the warrants. Bond insurance was obtained from three monoline insurers.

The Official Statements related to JeffCo’s 2002 and 2003 refunding issues identified that there were risks associated with the purchase of these sewer warrants. They identified as a risk the fact that the warrants did not have recourse to JeffCo, so that holders could look only to revenues of the sewer system for payment. It was also disclosed that the total cost of compliance with the Consent Decree could not be precisely identified and that there could be no assurance that sewer rates could be raised on a timely basis to satisfy all indebtedness.

**What went wrong?**

Where to start? Here’s a partial list:

- Criminal proceedings along with articles in the local press reflect that JeffCo’s sewer system rehabilitation efforts suffered from significant cost overruns, fraud, bribery and other improprieties in both the construction of the updated sewer system and its financing. Twenty-three people have been currently found to be or plead guilty.
- Interest rates on the auction rate warrants adjusted to higher default rates when the auction rate securities market froze in the winter of 2008, increasing the current interest burden on JeffCo.

- The downgrading of two of the three monoline bond insurers triggered the required purchase of the insured warrants by liquidity providers which, in turn, resulted in JeffCo's obligation to pay accelerated amortization of those warrants.
- JeffCo refused to increase sewer rates in accordance with the rate covenant in the sewer warrant indenture because, in its view, sewer rates were already too high and anything more would be unreasonable, excessive and, therefore, unenforceable. This decision led to the terminations of their interest rate swaps which, in the low interest rate environment, resulted in accelerated debt payment obligations for JeffCo of \$657 MM.

Despite this litany of trouble with the sewer system and its financing, the non-recourse nature of the sewer warrant debt meant that JeffCo might have been able to avoid its chapter 9 filing. Sewer warrant holders and their representatives were limited in the relief they could seek and had no means by which to reach JeffCo's general funds. After informal efforts to negotiate a solution to the problem, sewer warrant holders and their representatives started with a lawsuit in federal court, but even though the court felt there were grounds to appoint a receiver in accordance with the rate covenant in the indenture, the court stopped short because of the Johnson Act, a federal statute that prohibits a federal court from appointing a receiver with the power to set municipal rates. Switching to the state court system, sewer warrant holders and their representatives were able eventually to get a receiver appointed. The receiver implemented several operational improvements and is credited with good management of the sewer system with a resultant increase in sewer revenues. However, those improvements were never expected to be sufficient to satisfy the sewer warrants so the receiver readied a significant rate increase. This situation might have played itself out in the state court system for years as the parties argued over the reasonableness of the proposed rates and whether Alabama law imposed limitations on how high the receiver could raise them. If JeffCo could suffer the loss of control of its sewer system to a court appointed receiver who could set rates and collect sewer system revenues on behalf of warrant holders, JeffCo might just have been able to get along with the business of running the other aspects of a municipality.

But JeffCo's sewer systems problems do not exist in a vacuum. JeffCo provides many other services to its residents as you would expect from any municipality. These services were funded by the usual means with JeffCo looking to a variety of sources of revenues and having issued other types of general obligation indebtedness to fund its normal operations. One third of those revenues came from a business license and occupational tax. What appears to have been the proverbial straw that broke JeffCo's back and precipitated the chapter 9 filing was the action of the Alabama Supreme Court in striking down that tax as having been improperly implemented. As JeffCo does not have taxing power, it must get the state legislature approval to impose new taxes. To date, the Alabama state legislature has not approved a new business and occupational or any other tax to replace JeffCo's lost revenues. As a result, JeffCo, operating with significantly reduced revenue, instituted severe layoffs and other service cutbacks in a vain attempt to bring its current expenditures in line with current revenues. Ultimately, with no way to increase revenues, JeffCo defaulted on its general obligation debt. While a settlement was reached with the sewer warrant holders and their representatives, implementation of that settlement also required certain actions from the state legislature that again would not come to JeffCo's rescue. With nowhere else to turn, JeffCo filed its chapter 9 case on November 9, 2011.

## **Chapter 9 Decisions to Date.**

Since JeffCo's chapter 9 filing, the bankruptcy court has been forced to address several somewhat novel issues. Because chapter 9 cases are not as abundant as chapter 11 or 7 bankruptcy cases, less case law has developed over time to guide the parties or the courts when issues arise. And issues in the JeffCo chapter 9 case are plentiful.

### **Receivers and Rate Covenants**

The case began with uncertainty about the continued role of the state court appointed receiver. This first issue was resolved by the bankruptcy court on January 6, 2012 in a decision that had the result of requiring that the sewer system be returned to JeffCo's control. The receiver is still in place, but his role is limited to receiving whatever net sewer revenues are delivered to him by JeffCo. The bankruptcy court concluded that the only it has jurisdiction over JeffCo's assets and the automatic stay that arises upon the filing of the chapter 9 petition stops the state court proceeding from going any further. As a result, the automatic stay also stops the Receiver who had been appointed by that state court and the state court receiver must return the sewer system to JeffCo. As a result, implementing the rate covenant in the sewer warrant indenture has suffered another setback given JeffCo's past unwillingness to increase sewer rates and, perhaps little incentive to do so during the chapter 9 case as it uses the leverage of rate increases to negotiate an acceptable restructuring of the sewer warrants. While the bankruptcy court can always be asked to revisit its decision, and might do so if there were evidence that JeffCo cannot adequately run the sewer system, at least for the present time JeffCo can run the sewer system and has the ability to adjust rates or not.

### **Special Revenues and Post-Petition Receipts**

In that same decision, the bankruptcy court determined the rights of sewer warrant holders to post-chapter 9 filing revenues. JeffCo made the argument that only revenues in the hands of the Receiver at the time of the filing of the chapter 9 case were available to be paid to warrant holders. The bankruptcy court disagreed. Informed by the legislative history that surrounded the 1988 amendments to the Bankruptcy Code which added Section 928 to the statutory scheme, the bankruptcy court determined that the Congressional intent behind Section 928 was to ensure that a pre-petition lien on special revenues would continue on special revenues collected after the filing of the chapter 9 case and that net post-petition special revenues should be delivered to the holders of the special revenue debt. The decision is comforting to special revenue warrant holders as, with one qualification, all pledged special sewer revenues, whether generated prior to or after the filing of the chapter 9 case, will continue to be paid and have been paid to the holders of JeffCo's sewer warrants. The qualification applies to the costs of operating the sewer system. Chapter 9 converts a gross pledge of special revenues into a net pledge. While the Indenture's pledge of JeffCo's sewer revenues was in fact a net pledge, there is nothing in the Bankruptcy Code saying that a bankruptcy court is bound by the Indenture's definition of which sewer system operating expenses should be taken out of gross revenues before the net amount is turned over to the Indenture Trustee. This allows JeffCo to argue that there are additional costs of operating the system, not listed in the Indenture, which should be deducted from current revenues before the net amount is delivered to sewer warrant holders.

## **Eligibility for Chapter 9**

In a separate dispute, representatives of sewer warrant holders challenged the very right JeffCo to file its chapter 9 case. If warrant holders could knock the case out of the bankruptcy court, they could get the sewer system back into the hands of the state court appointed Receiver and move forward with the expected sewer rate increases. At issue was whether Alabama's statutes authorizing its municipalities to file chapter 9 cases required that the municipality have bond debt as a prerequisite. JeffCo has issued warrants but no bonds were outstanding. As had become somewhat common in municipal politics and finance in Alabama, municipalities avoided bond debt in favor of issuing warrants because the issuance of bonds required voter approval while the issuance of warrants did not. On March 4, 2012, the JeffCo bankruptcy court decided that outstanding indebtedness on bond debt is not required for an Alabama municipality to file a chapter 9 case. While the decision has been appealed, the Alabama Supreme Court, considering an appeal in a separate chapter 9 case involving the City of Pritchard, Alabama, has just ruled in line with the JeffCo bankruptcy court. It is likely that the Pritchard decision will put an end to the issue in the JeffCo case and that JeffCo will now remain in Chapter 9 to fight another day.

### **Chapter 9 Decisions to Come.**

Looking only at the sewer warrants, there are still lots of things to fight about in the JeffCo bankruptcy. At present there is a hearing taking place over what operating costs can be deducted by JeffCo from current sewer revenues before net sewer revenues are delivered to the representatives of sewer warrant holders. As mentioned above, holders of special revenue debt may not be able to rely upon the indenture's definition of expenditures that may be paid from special revenues before the balance is turned over to pay special revenue debt. The key disputes are over how to fund the sewer system's future capital expenditures, the use of a reserve fund and depreciation.

There is also a question whether the sewer warrants might enjoy a statutory lien on sewer system revenues and whether a statutory lien has different attributes in a chapter 9 case than a lien created by agreement, such as the indenture at issue in JeffCo. This, in turn, may implicate the operating expense issue.

But despite all of these preliminary skirmishes, the ultimate test will be the plan by which JeffCo hopes to emerge from chapter 9. The standards that apply to a bankruptcy court decision to approve such a plan are not well developed. There is a possibility if negotiations continue to be unproductive, that JeffCo will seek to confirm a plan over the objection of sewer warrant holders, a process called cramdown. This approach requires that the bankruptcy court value the future stream of sewer system revenues in order to determine the proper amount of the warrant holders' secured claim. In order to do so, the bankruptcy court will have to tackle the problem of predicting the rates users of the sewer system will have to pay over time. That's certainly a Gordian Knot if one ever existed.

But the JeffCo issues, as discussed above, exceed the limited world of JeffCo's sewer system and the warrants issued to fund its acquisition and improvement. Ultimately, JeffCo must find the means by which to bring its general obligation debt in line with its currently reduced

sources of general revenue. Whether the State of Alabama will continue to let JeffCo twist in the wind by limiting its ability to tap other sources of revenue is anyone's guess.

### **Implications-The Big Picture**

Bankruptcy court has always been a bit of a strange place for those not accustomed to its workings. With the benefit of a unique federal statute, and its own procedural rules, along with its own peculiar language, things sometimes happen in bankruptcy cases that seem at odds with the expectations of those who exist only in the non-bankruptcy world. This is especially true in the context of a chapter 9 case where a limited number of prior chapter 9 cases means there is limited judicial precedent to inform future decision-making. This lack of predictability can result in parties feeling their way as if they were explorers venturing forth from the shores of Europe to find and explore the New World. In this respect, the JeffCo bankruptcy court's decisions add substantial weight to the body of law that provides guidance for municipal bondholders and their advisors. Subject to the possibility that one of the bankruptcy court's decisions will be reversed on appeal, here is what we have learned so far:

- **Eligibility:** In order to file a chapter 9 case, the municipality must meet specific eligibility tests established in the Bankruptcy Code, including that the state in which the municipality sits has specifically authorized its municipalities in general or this municipality in this instance, to file a chapter 9 case. Less than half of the states currently authorize their municipalities to utilize chapter 9. In each chapter 9 case, there is inevitably a contest over whether the municipality has met the required criteria. The City of Harrisburg, PA, faced such a dispute with the bankruptcy court deciding that the case should be dismissed. At least in Alabama, with the benefit of the *Pritchard* decision, it is now settled that municipalities can file chapter 9 cases without having bond indebtedness outstanding. However, anyone acquiring municipal debt should look at whether the issuer can file a chapter 9 case and, if so, under what circumstances.
- **Special Revenues:** The JeffCo court's ruling about post-petition special revenues is significant. The market for municipal debt relies upon the premise that special revenues will be paid to the holders of the special revenue debt regardless of whether chapter 9 intervenes. A ruling to the contrary would likely have had a significant negative impact on the market's willingness to accept new issuances of special revenue debt and severely impacted in a negative manner the value of special revenue debt previously issued. While the JeffCo bankruptcy court ruling is not binding on bankruptcy courts in other parts of the country, it is thorough in its analysis and likely to be influential should the issue arise in another chapter 9 cases. Subject to resolution of the appropriate operating expenses to be paid from gross special revenues, holders of special revenue bonds can expect to continue receiving payments from special revenues generated after the filing of the chapter 9 petitions.
- **Rate Covenants:** The rate covenant is important to special revenue debt issuance because the only way to ensure that project revenues will be sufficient to pay debt service is to be able to raise rates from time to time. Otherwise, given

the non-recourse nature of the debt, the municipality would have no incentive to raise rates while the debt is outstanding. Such a result would unnecessarily restrict the amount of debt a municipality could issue through special revenue debt as purchasers of debt would be unwilling to finance more than could be supported by current rates.

The JeffCo experience shows how difficult it can be for debt holders to enforce a rate covenant. First was the failure in the federal court. Second was a long delay before getting the Receiver appointed in state court. Now, that achievement has been reversed by the filing of the chapter 9 case. Based upon the reasoning of the JeffCo bankruptcy court, the filing of a chapter 9 case puts the rate covenant at least on the back burner. In this respect it is similar to the impact of bankruptcy upon remedies ordinarily available to secured lenders in commercial bankruptcy cases governed by chapters 7 and 11 of the Bankruptcy Code. The automatic stay that arises upon a bankruptcy filing stops all creditor collection efforts with the creditors having to come to the bankruptcy court to get relief from the automatic stay, usually because they cannot be adequately protected or because the business cannot be successfully reorganized.

It is possible that the rate covenant will be important in another context. Should there be an attempt to value the sewer warrant holders' collateral, i.e. a stream of special revenue produced by JeffCo residents paying for the sewer system usage at an established rate, it is only reasonable to expect that any valuation analysis will have to take into account the rate at which residents will be required to pay in the future.

- **Disclosure:** It is also reasonable to expect that the list of risks disclosed in the offering documents for any future issuance of municipal debt will be more robust than has been typical of past issuances. Among these risks should be the possibility that the issuer might become subject to a chapter 9 proceeding with its attendant risks for various kinds of municipal debt.

## **Conclusion**

The preliminary skirmishes in JeffCo are now behind us, but its future path is still hard to map out. However, with each ruling issuers and purchasers of municipal debt gain valuable guidance about how various types of municipal debt might be treated in a municipal chapter 9 case. The discussion about the possibility of the municipal issuer becoming the debtor in a chapter 9 case is likely to become more robust in future public disclosure documents and the purchasers of municipal debt are likely to be able to make more informed decisions.

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