

# Jefferson County: The Bankruptcy Court Always Wins

January 19, 2012 by [Douglas Mintz](#), [Alicia B. Davis](#) and [Timothy T. Brown](#)

*In re Jefferson County, Alabama*, Case No. 11-05736 (TBB) (Bankr. N.D. Ala. Jan. 6, 2012).

On January 6, 2012, Judge Thomas B. Bennett of the Bankruptcy Court for the Northern District of Alabama held that (i) the Alabama state receivership court lost possession and control over Jefferson County's property interests in its sewer system immediately upon the filing of the County's chapter 9 bankruptcy case and (ii) special revenue warrants are exempt from the automatic stay and must continue to be serviced during the course of a chapter 9 case. This decision highlights the loss of control that municipal bondholders face when a municipality files for bankruptcy relief under chapter 9 of the Bankruptcy Code and the special treatment afforded to special revenue bonds in chapter 9.

The County's financial woes stemmed from the combination of a crushing debt load and the untimely loss of certain unearmarked tax revenues. The vast majority of the County's debt was attributable to approximately \$3.6 billion in warrants issued by the County between 1997 to 2003 to finance the overhaul of its sewer system. Initially, the warrants bore fixed rates, however, starting in 2001, the County began issuing variable rate and auction rate warrants hoping to lower its interest rates. The auction rate securities market dried-up in 2007, and by April 2008, the County could not make principal payments on certain of its outstanding warrants. In response, the Indenture Trustee for the holders of the warrants filed suit in Alabama state court seeking to enforce the terms of the indenture. The Alabama court granted partial summary judgment in favor of the Indenture Trustee and appointed a receiver over the County's sewer system to administer the sewer system in accordance with the indenture. The Receiver was granted exclusive control of the sewer system and was empowered to fix and charge sewer rates. Although the Receiver implemented many needed reforms, the Receiver was unable to decrease meaningfully the sewer system's mounting debt.

To make matters worse, in March 2011, the Alabama Supreme Court struck down the County's business license and occupation tax – the primary source of tax revenues that were not earmarked for specific purposes – on the basis that the tax was passed improperly by the Alabama legislature. In response to the County's fiscal crisis, the County reached out to the Receiver and the County's creditors in hopes of consensually restructuring the County's debts. On September 16, 2011, the Jefferson County Commission approved a term sheet with the Receiver in furtherance of a proposed settlement between the County and its creditors. However, the settlement was never finalized, and on November 9, 2011, the County filed for bankruptcy relief under chapter 9 of the Bankruptcy Code.

The Indenture Trustee filed a motion with the bankruptcy court asking the court to find, among other things, (i) that the Alabama state court retained jurisdiction over the sewer system such that the Receiver is entitled to continue to act as the receiver of the County's sewer system and (ii) that the automatic stay imposed by the Bankruptcy Code did not apply to the Receiver. Regarding the jurisdictional issue, the bankruptcy court found that pursuant to 28 U.S.C. §§ 1334(a) and 1334(e)(1), the bankruptcy court had exclusive jurisdiction over the County as a municipal debtor and its property. Furthermore, the bankruptcy court found that notwithstanding the appointment of the Receiver, the County retained ownership of and title to the real and personal properties that constituted the sewer system. The bankruptcy court reasoned that under Alabama receivership law and applicable Supreme Court precedent, neither the Receiver nor the appointing court had an interest in the sewer system, other than holding the sewer system in *custodia legis*. Therefore, the court held that "the County's bankruptcy case automatically and immediately transferred the properties held by the Receiver from the Alabama receivership court to [the bankruptcy court's] exclusive jurisdiction under the grant of 28 U.S.C. § 1334(e)(1) and the Receiver, at best, holds the County's sewer system for [the bankruptcy court], not another court."<sup>[1]</sup>

The bankruptcy court also held that the automatic stay set forth in sections 362(a) and 922(a) of the Bankruptcy Code prevented the Receiver from taking any further action in the Alabama receivership case. The bankruptcy court reasoned that section 362(a)(5) of the Bankruptcy Code “stops actions in the receivership case and by the Receiver constituting creation, perfection or enforcement of a lien against property of the County.”<sup>[2]</sup> However, the bankruptcy court also found that pursuant to section 922(d) of the Bankruptcy Code, the automatic stay did not apply to the pledged special revenues over which the Indenture Trustee has a lien under the indenture. Section 922(d) provides that “[n]otwithstanding section 362 . . . a petition filed under this chapter does not operate as a stay of application of pledged special revenues . . . to payment of indebtedness secured by such revenues.”<sup>[3]</sup> Accordingly, the bankruptcy court held that for the post-bankruptcy period, all revenues against which the Indenture Trustee has a lien “should be continually paid to the Indenture Trustee for the benefit of the warrant holders consistent with contractual requirements.”<sup>[4]</sup>

Judge Bennett’s decision in Jefferson County should bring both comfort and concern to municipal bondholders. On the one hand, the decision highlights the fact that municipal bondholders have limited control over a municipality once it enters chapter 9 – regardless of what protections the bondholders obtained prepetition. On the other hand, the decision reaffirms a fundamental precept of municipal finance, *i.e.*, that special revenue bonds will continue to be secured and serviced during a chapter 9 bankruptcy case.

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[1] *In re Jefferson County, Ala.*, Case No. 11-05736 (TBB), at \*2 (Bankr. N.D. Ala. Jan. 6, 2012)

[2] *Id.* at \* 29.

[3] 11 U.S.C. § 922(d).

[4] *In re Jefferson County, Ala.*, at \* 2.