Chapter 9 Descends Into the Sewer to Clean Up

March/April 2012

Joseph M. Witalec
Mark G. Douglas

One option available to many cities, towns, and other municipalities in the United States that are teetering on the brink of financial ruin in the aftermath of the Great Recession is chapter 9 of the Bankruptcy Code, a once obscure legal framework that allows an eligible municipality to "adjust" its debts by means of a "plan of adjustment" that is in many respects similar to the plan of reorganization a debtor can devise in a chapter 11 case. However, due to constitutional concerns rooted in the Tenth Amendment's preservation of each state's individual sovereignty over its internal affairs, the resemblance between chapter 9 and chapter 11 is limited.

The contrasts between chapter 9 and other chapters of the Bankruptcy Code were highlighted in a ruling recently handed down by the Alabama bankruptcy court presiding over the largest municipal bankruptcy in U.S. history. In *In re Jefferson County, Alabama*, 2012 WL 32921 (Bankr. N.D. Ala. Jan. 6, 2012), the court denied a state-court-appointed receiver's request to retain control of the debtor's sewer system, holding that the bankruptcy court had exclusive jurisdiction over the property and that the automatic stays imposed by sections 362 and 922 of the Bankruptcy Code precluded continuation of the receiver's stewardship. The bankruptcy court also refused to abstain from hearing the bankruptcy case or to modify the automatic stays. However, the court ruled that the stays did not preclude the continuation of payments to warrant holders from the sewer system's pledged revenue stream, net of any necessary operating costs.

Municipal Bankruptcy Law

Ushered in during the Great Depression to fill a vacuum that previously existed in both federal and state law, federal municipal bankruptcy law suffered from a constitutional flaw that endures in certain respects to this day—the Tenth Amendment reserves to the states sovereignty over their internal affairs. This reservation of rights caused the U.S. Supreme Court to strike down the first federal municipal bankruptcy law as unconstitutional in 1936, and it accounts for the limited scope of chapter 9, as well as the severely restricted role the bankruptcy court plays in presiding over a chapter 9 case and in overseeing the affairs of a municipal debtor.

The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and bailout by the New York State government in 1975, but chapter 9 has proved to be of limited utility thus far. Few cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings have involved municipal instrumentalities, such as irrigation districts, public-utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 650 municipal bankruptcy petitions have been filed in the more than 70 years since Congress established a federal mechanism for the resolution of municipal debts. Fewer than 300 chapter 9 cases have been filed since the current version of the Bankruptcy Code was enacted in 1978—although the volume of chapter 9 cases has increased somewhat in recent years. By contrast, there were 11,400 chapter 11 cases filed in 2011 alone.

Constitutional Compromises

In an effort to mollify constitutional concerns associated with subjecting a state instrumentality to the jurisdiction and control of a federal court, section 903 of the Bankruptcy Code expressly reserves to the states the power to control municipalities that file for chapter 9 protection, with the caveat—and the significant limitation—that any state law (or judgment entered thereunder) prescribing a method of composition of indebtedness among a municipality's creditors is not binding on dissenters. In addition, section 904 provides that, unless the debtor consents or its plan of adjustment so provides, a federal bankruptcy court may not "interfere" with any of the debtor's "political or governmental powers," any of the debtor's property or revenues, or the debtor's use or enjoyment of its income-producing property. Thus, unlike a chapter 11 debtor, a municipal debtor is not restricted in its ability to use, sell, or lease its property (section 363 does not apply in a chapter 9 case), and the court may not become involved in the debtor's day-to-day operations. Also, unlike in a case under chapter 7, 11, 12, or 13 of the Bankruptcy Code, a municipal debtor's assets do not become part of a bankruptcy estate upon the filing of a chapter 9 petition. Accordingly, section 902(1) of the Bankruptcy Code provides that " 'property of the estate', when used in a section that is made applicable in a case under [chapter 9] by section 103(e) or 901 of [the Bankruptcy Code], means property of the debtor."

Control of a municipal debtor under chapter 9 is not subject to defeasance in the form of a bankruptcy trustee (although state laws commonly provide a mechanism for transferring control of the affairs of a distressed municipality to an emergency manager or similar entity). A trustee, however, may be appointed to pursue avoidance actions (other than preferential transfers to or for the benefit of bondholders) on behalf of the estate if the debtor refuses to do so. A municipal

debtor generally is not subject to the reporting requirements and other duties of a chapter 11 debtor.

A chapter 9 debtor enjoys many of the rights of a chapter 11 debtor in possession but is subject to fewer of the obligations. Pursuant to sections 103(f) and 901(a), many provisions elsewhere in the Bankruptcy Code are expressly made applicable to chapter 9 cases. These include, among others, provisions regarding the automatic stay (with certain exceptions); adequate protection; postpetition financing; executory contracts; administrative expenses; a bankruptcy trustee's "strong arm" and avoidance powers; financial contracts; the formation of official committees; and most, but not all, of the provisions governing vote solicitation, disclosure, and confirmation of a chapter 11 plan. The incorporated provisions do not include, among others, sections 542 and 543, which mandate turnover to the estate of any of the debtor's property held by third parties and custodians (respectively) on the bankruptcy petition date.

Chapter 9 also includes a separate automatic stay in section 922 of the Bankruptcy Code. Section 922(a) provides that, "in addition to the stay provided by section 362," the filing of a chapter 9 petition operates as a stay of:

> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against an officer or inhabitant of the debtor that seeks to enforce a claim against the debtor; and
>
> (2) the enforcement of a lien on or arising out of taxes or assessments owed to the debtor.

Section 922(b) provides that subsections (c), (d), (e), (f), and (g) of section 362 of the Bankruptcy Code "apply to a stay under subsection (a) of this section the same as such

subsections apply to a stay under section 362(a).” This means, among other things, that section 362(b)’s exclusions of certain designated acts from the scope of the automatic stay, including (pursuant to section 362(b)(4)) actions by a “governmental unit” to enforce its “police and regulatory powers,” do not apply to a stay under section 922(a).

However, section 922(d) excludes certain acts from the scope of the stay under section 922(a) by providing that “[n]otwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues.”

Jefferson County

Perched in the foothills of the Appalachian Mountains, Jefferson County, Alabama (the “County”), is home to 660,000 residents and the state’s largest city (Birmingham). Between 1997 and 2003, the County issued nearly $3.7 billion in “special revenue” warrants to finance the construction and repair of a sewer system. The warrants are backed by sewer-system revenues, but the obligations are not otherwise secured by the underlying sewer-infrastructure assets. The County chose this form of financing because in Alabama (and many other states), special-revenue warrants, unlike bonds, do not require voter approval. In addition, such warrants are not commonly tallied in computing debt limits imposed by states on municipalities, and like many other states, Alabama does not generally allow a municipality to pledge its property to secure debt.

Owing to a combination of mismanagement, fraud, corruption, and market failures (including a failed combination of swap and interest-rate stabilization agreements), the County defaulted on the warrants and the governing indenture in February 2008. In September 2008, the indenture trustee (the "Indenture Trustee") and certain other parties sued the County and its commissioners in an Alabama federal district court seeking, among other things, the appointment of a receiver to take over the sewer system. The district court ruled in June 2009 that there was sufficient cause to appoint a receiver, but it abstained from doing so because the Johnson Act, 28 U.S.C. § 1342, provides that, under certain circumstances, a federal court shall not "enjoin, suspend or restrain the operation of, or compliance with, any order affecting rates chargeable by a public utility and made by a State administrative agency or a rate-making body of a State political subdivision."

In August 2009, the Indenture Trustee asked an Alabama state court to appoint a receiver for the sewer system. The state court granted partial summary judgment in favor of the trustee in September 2010, appointing John S. Young, Jr., LLC, as receiver (the "Receiver") for the sewer system and entering a judgment against the County for more than $500 million, to be paid solely from revenues identified in the indenture. Among other things, the state court's order provides that the Receiver is forbidden, without some future "express order of [the Alabama court,] to sell or otherwise dispose" of the sewer system or any part of it. It also does not alter the ownership and title to the sewer-system properties. Finally, the order specifies that "the Receiver and the Receiver Affiliates are not and shall not be considered public officials or public employees for any purpose."

After taking over the sewer system, the Receiver: (i) began to develop a plan for rate increases and increased efficiencies designed to make the County's obligations under the indenture sustainable; and (ii) facilitated negotiations among the County, the Indenture Trustee, and other stakeholders that ultimately resulted in a settlement in principle. On September 16, 2011, County commissioners voted to accept a restructuring agreement that, with the approval of the state legislature (among others), would have allowed the County to shed about $1 billion in debt and lower the interest rate on roughly $2 billion of new, 40-year debt that would have been issued to replace the existing debt.

The settlement was never finalized. Instead, the County filed a petition for relief under chapter 9 on November 9, 2011, in the Alabama bankruptcy court. The County's chapter 9 case involves more than $4 billion in debt, dwarfing the $1.7 billion bankruptcy of Orange County, California, in 1994, which had been the largest municipal bankruptcy case on record. More than three-quarters of the County's total debt has arisen in connection with the sewer system.

Immediately after the chapter 9 filing, the Indenture Trustee, the Receiver, and various other parties filed an emergency motion seeking an order of the bankruptcy court: (i) abstaining from taking any action to interfere with the Alabama state-court receivership case for the sewer system; (ii) determining that the automatic stays imposed by sections 362 and 922 do not apply to the receivership case or the Receiver; (iii) directing that the Receiver is entitled to continue in that capacity; and (iv) if the court were to determine that the automatic stays apply, modifying the stays to allow for continuation of the receivership case.

The Bankruptcy Court's Rulings

Whose Property Is It Anyway?

At the outset, the court examined the competing property interests asserted by the Receiver and the County in the sewer system and its revenue stream. The court concluded that, under applicable law (here, Alabama state law), a receiver has no interest in property under its supervision other than control and possession on behalf of the appointing court. Nor, the court explained, does the appointing court have any interest in the property other than holding such property *in custodia legis*. According to the court, these limitations were very clearly spelled out in the receivership order, which was nothing more than "an order giving a private creditor a contracted for and statutory remedy to enforce portions of the indentures and warrants designed to protect interests of the warrant holders."

Because legal title and ownership of the sewer system resided with the County, the bankruptcy court concluded that, upon the filing of the County's chapter 9 petition, 28 U.S.C. § 1334(e)(1) gave it exclusive jurisdiction "of all of the property, wherever located, of the debtor," thereby divesting the state court of jurisdiction over the sewer system. Moreover, the court emphasized, the automatic stays in sections 362 and 922 of the Bankruptcy Code thereafter precluded any actions by the Receiver or the Indenture Trustee impacting the County's rights in the sewer system.

The court rejected the Receiver's argument that the omission of turnover under section 543 from the list of provisions applicable in chapter 9 exempts the receivership case from the scope of the stays. According to the court, "Since no creditor had possession of any of the County's property comprising the sewer system, this makes the state court's possession of it via the Receiver not

the equivalent of a creditor possessing property of a debtor." In other words, the court explained, the County had "no need of [section 543]." Moreover, the court emphasized, the absence of sections 542 and 543 from chapter 9 does not in any way impact the *in rem* jurisdiction of a bankruptcy court over a chapter 9 debtor's property, nor does it somehow make the stays of sections 362 and 922 inapplicable to creditor actions affecting that property.

No Police-Power Exception

The court also ruled that the Receiver and the Indenture Trustee could not rely on the "police and regulatory powers" exception to the automatic stay set forth in section 362(b)(4) of the Bankruptcy Code. As described above, by operation of section 922(b), that exception does not apply with respect to the stay automatically arising under section 922(a). Furthermore, the court explained, neither the Indenture Trustee nor the Receiver is a "governmental unit" within the meaning of the provision, and the Indenture Trustee's actions, including its request for the appointment of a receiver, "are those of a private party, not Alabama, seeking to enforce a contract."

Special Revenues Protected

The court then assessed the effect of section 922(d), which, as noted, exempts from the automatic stays the application of "pledged special revenues" to a debt secured by such revenues. The County contended that the term "pledged" in this context refers only to "special revenues" (defined in section 902(2)) that are actually in the possession of the Indenture Trustee on the bankruptcy petition date, as distinguished from postpetition revenues.

The court carefully examined the meaning of "pledge" in both common and legal usage, as well as the legislative history underpinning section 922(d). It concluded that the provision refers to pledged funds in the possession of a creditor on the petition date as well as the future revenue stream. According to the court, excerpts from the legislative history of amendments to the Bankruptcy Code in 1988 (which, among other things, added subsection (d) to section 922), indicate that sections 922(d) and 928 (regarding the postpetition effect of a security interest) were intended to preserve creditors' liens on municipal special revenues that might otherwise be avoided by operation of section 552(a). However, the court acknowledged that, pursuant to section 928(b), liens on special revenues are subject to the "necessary operating expenses" of the assets from which they are derived. The court left for another day the determination of the amount of necessary operating expenses that could be used from the pledged revenues to run the sewer system, and the parties are currently litigating that issue in front of the court.

Abstention/Stay Relief Unwarranted

Finally, the court ruled that no basis existed for it either: (i) to abstain from presiding over either the County's chapter 9 case under section 305, which does not apply in chapter 9, or any particular controversy arising in connection with the case, pursuant to the mandatory or discretionary abstention provisions set forth in 28 U.S.C. § 1334(c); or (ii) to modify the automatic stays under section 362(a) or 922(a). Among other things, the court found that such relief was unwarranted, given the fact that a new set of county commissioners had been elected who were not involved in the mismanagement, fraud, and corruption alleged to have plagued the sewer system and to have precipitated the financial crisis that propelled the County into bankruptcy. However, the bankruptcy court did not foreclose the possibility that it might grant such relief in the future under appropriate circumstances.

Outlook

Jefferson County is an important ruling. For participants in municipal special-revenue financing transactions, the decision is significant because it confirms their right to an uninterrupted flow of pledged revenues after a municipal bankruptcy filing, subject to charges for necessary operating expenses. The most compelling takeaway from *Jefferson County*, however, is arguably the ruling's reaffirmation of the hegemony (albeit temporary and limited) of federal bankruptcy courts over the assets of a chapter 9 debtor—once a chapter 9 petition is filed, the bankruptcy court has exclusive jurisdiction over all of a municipal debtor's property, wherever located (and by whomever held). That jurisdiction supplants any jurisdiction previously asserted by other courts and (unless specified otherwise in the Bankruptcy Code) precludes creditors from acting against the debtor or its property.

Jefferson County also illustrates some important distinctions between chapter 9 and other chapters of the Bankruptcy Code premised upon the differences between municipal debtors and other kinds of debtors. For example, the court's denial of the bid by the Receiver and the Indenture Trustee to retain control of the sewer system reaffirms the mandate underpinning chapter 9 that a municipal debtor have exclusive control of its assets during the bankruptcy case (as provided in section 904). In addition, the ruling shines a spotlight on the supplemental stay in section 922—relief that is not automatically available in other bankruptcy cases (although it could conceivably be granted under certain circumstances in the court's discretion).

Another noteworthy difference between chapter 9 and other chapters of the Bankruptcy Code cases highlighted in *Jefferson County* is (as noted previously) the absence of a bankruptcy estate

in chapter 9. The court was very careful to characterize the sewer-system assets as property of the debtor, rather than its bankruptcy estate. This distinction is also rooted in the constitutional compromises embodied in chapter 9. If a bankruptcy estate were established in chapter 9, the court and other stakeholders would, by virtue of various provisions in the Bankruptcy Code, be in a position to exert constitutionally impermissible control over a municipal debtor's assets.

The fireworks in the County's chapter 9 case are far from over. This is not surprising, given the large amount of money at stake, the provenance of the County's financial problems, and the precedential ramifications of the court's rulings. On February 29, 2012, the bankruptcy court certified a direct appeal of the ruling in *Jefferson County* to the Eleventh Circuit Court of Appeals, concluding, among other things, that the decision "involves a matter of public importance" with respect to which there is no controlling Eleventh Circuit precedent. On March 4, 2012, despite objections by the Indenture Trustee and certain other creditors, the bankruptcy court ruled that the County is eligible to be a chapter 9 debtor under Alabama's limited chapter 9 authorization statute. Among other things, the court determined that the sewer-system warrants issued by the County qualified as "debt" for purposes of chapter 9. Bank creditors have also asked the bankruptcy court to certify a direct appeal of this ruling to the Eleventh Circuit. In addition, the bankruptcy court has scheduled a hearing in April to determine the appropriate amount of "necessary operating expenses" that the County can deduct from the sewer system's special-revenue stream that is payable to the holders of the County's warrants. Stay tuned for further developments.

A version of this article was published in the March 7, 2012, edition of *Bankruptcy Law360*. It has been reprinted here with permission.