SOUTHERN DISCOMFORT: AN EXAMINATION OF THE FINANCIAL CRISIS IN JEFFERSON COUNTY, ALABAMA

I. INTRODUCTION

Jefferson County, Alabama may soon be at the top of a very exclusive list. This list includes such other notable municipal governments as Orange County, California and New York, New York. However, this "honor" is not one for which Jefferson County—nor any municipality for that matter—would seek. As things currently stand, and if events continue along their current path, Jefferson County, Alabama will have the honor of declaring the largest municipal bankruptcy in the history of the United States.[1]

The reasons Jefferson County finds itself in such difficulty are many and varied. This paper examines several potential causes of the crisis. First, the paper walks through the events that led to the County's incurring such an immense amount of debt. Second, the paper explores factors distinct to Jefferson County alone that may have precipitated its current financial crisis. The final section examines the financial products used by the County in these financings, looking at the products themselves and how Jefferson County used them, further exploring how that use may have led the County to its present position on the brink of bankruptcy.

A. *Background*

1. EPA Ruling and Consent Decree

Jefferson County's problems began in 1993 when three residents living along the Cahaba River filed a lawsuit.[2] In that suit, the residents claimed that untreated sewage was being discharged from county treatment plants into local rivers, including the Cahaba River,[3] a major source of drinking water for the area.[4] The Cahaba River Society and the Environmental Protection Agency ("EPA") subsequently joined litigation efforts

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1. See Bloomberg News, *Alabama County Prepares for a Possible Bankruptcy*, N.Y. TIMES, Aug. 27, 2008, at C4.
2. Martin Z. Braun, Darrell Preston, & Liz Willen, *The Banks That Fleeced Alabama*, BLOOMBERG MARKETS, Sept. 2005, at 56, *available at* http://www.mobilebaytimes.com/alabama.pdf.
3. *Id.*
4. *See* MELINDA LALOR & ROBERT PITT, ASSESSMENT STRATEGY FOR EVALUATING THE ENVIRONMENTAL AND HEALTH EFFECTS OF SANITARY SEWER OVERFLOWS FROM SEPARATE SEWER SYSTEMS 40 (1998), http://rpitt.eng.ua.edu/Publications/Inappropriate_Discharges/first%20year%20SSO%20report%20Jan%201999.pdf.

against Jefferson County in the same matter.[5] Subsequently, on January 20, 1995, the District Court for the Northern District of Alabama, Southern Division, found that the County and its sanitary sewer system (the "System") were in violation of the Clean Water Act[6] and instructed the County to enter into settlement negotiations with the EPA and other parties to the case.[7]

As a result of these negotiations, the court approved a Consent Decree between the County and the EPA on December 9, 1996.[8] This Consent Decree called for the County to put into place a plan to rectify the problems and significantly improve the sewer system within a 12-year period.[9] The plan was divided into phases; "[t]he first phase . . . was unification of the County's sewer system [sic] making the County responsible for all sewer lines."[10]

2. The Jefferson County Sewer System

"Unification" required the County to "take over sanitary sewers from 21 cities, make improvements to plants and 3,100 miles of sewers, and stop the multiple discharges of raw sewage into streams."[11] The project became a nightmare when it was found that some of the sewer systems were using the same clay pipes that had been laid down nearly a century before.[12]

> [T]he results . . . of decades of deferred maintenance were collapsing sewer lines which allowed infiltration and inflow of water during heavy rains, which flowed through the sewer lines to the sewer treatment plants, overwhelmed the capacity of those sewer treatment plants to cope with the volume and resulted in bypasses of raw

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5. *Id.* at 39.

6. Clean Water Act, 33 U.S.C. §§ 1251-1387 (2006).

7. Official Statement, Jefferson County, Alabama 56 (Feb. 12, 1997), http://jeffco.jccal.org/pls/portal/docs/PAGE/FINANCE_PAGE_GROUP/GENERAL_OBLIGATION_WARRANTS/TAB49038/1997-A-B-C-SEWERREFUNDING.PDF [hereinafter 1997 Official Statement].

8. *Id.*

9. COMMISSIONER JIM CARNS, JEFFERSON COUNTY SEWER CONSENT DECREE, EXECUTIVE SUMMARY 2, http://www.jimcarns.com/pdfs/execsummary.pdf (last visited May 29, 2010).

10. *Id.*

11. Jeff Hansen, *How Debt Became a Crisis for Jeffco Complicated Financing Made County Vulnerable*, BIRMINGHAM NEWS, Mar. 9, 2008, at 1A.

12. Brian Burnsed, *Financial Crisis Shock Waves Reach Municipalities*, BUSINESSWEEK, Sept. 29, 2008, at 7, *available at* http://www.businessweek.com/bwdaily/dnflash/content/sep2008/db20080928_104955.htm.

> sewage into the rivers and streams of Jefferson County.[13]

The sewer systems throughout Jefferson County had not been maintained for 60 or 70 years and now the County was required to improve the entire System in only 12 years![14] The magnitude of the repairs required to upgrade the system was much more than the County had envisioned when it approved the 1996 Consent Decree.[15]

3. Financing the Improvements

The County originally estimated that the cost for these improvements would be approximately $1.2 billion.[16] While this was a significant amount, the commissioners reasoned that the amount could be covered by small annual increases in the sewer rates.[17] However, twelve years later, the "significant" figure of $1.2 billion had nearly tripled, with the outstanding sewer debt standing at $3.2 billion.[18]

The first financing for the improvements took place in 1997.[19] At that time, the County issued several series of warrants payable solely from revenues generated by the System.[20]

In 2002, Larry Langford was appointed County Commission President, having been elected to the Commission on a promise of reining in costs.[21] He was soon approached by Charles E. LeCroy, a banker with JPMorgan Chase, who had been instrumental in helping the County finance the original improvements to the System.[22] LeCroy now urged the County to reduce its interest payments by refinancing its debt and

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13. AMERICAN ENTERPRISE INSTITUTE, THE LARGEST MUNICIPAL BANKRUPTCY EVER?: JEFFERSON COUNTY AND MUNICIPAL FINANCE IN WAKE OF THE BUBBLE 7 (Sept. 9, 2008), *available at* http://www.aei.org/events/filter.all,eventID.1773/transcript.asp [hereinafter AEI Transcript].

14. *See id.* (estimating the duration of neglect, but misstating the timeframe for implementation of the settlement); CARNS, *supra* note 9, at 2 (correctly stating the timeframe for implementation of the settlement).

15. AEI Transcript, *supra* note 13.

16. Hansen, *supra* note 11.

17. *See id.*

18. *Id.*

19. *See* 1997 Official Statement, *supra* note 7, at 1.

20. *Id.* at 2.

21. Kyle Whitmire & Mary Williams Walsh, *High Finance Backfires on Alabama County*, N.Y. TIMES, Mar. 12, 2008, at C1.

22. *Id.*

switching from fixed to adjustable rates, and then hedging those financings with swaps.[23]

As noted previously, the County ended up issuing variable rate obligations totaling more than $3 billion.[24] At the same time, it entered into eighteen swap agreements with a notional amount of more than five and a half billion dollars.[25]

4. The Crisis

> Towns of various sizes are turning to swaps. But Jefferson County – population 660,000, about one-third of whom live in Birmingham, and 2004 revenue of $534 million – has exposure that rivals some of the biggest hedge funds: 18 interest-rate swaps with a notional, or total underlying value, of $5.8 billion. By way of comparison, Houston – the Texas town of two million people with 2004 revenue of $2.6 billion and about 80% more debt than Jefferson County – has two swaps with a total notional value of $850 million.[26]

The swaps were supposed to hedge the County's possible exposure on its variable rate obligations,[27] obligations that now amount to 94% of the County's debt.[28] Unfortunately for Jefferson County, these hedges did not work.[29]

Although Jefferson County did not invest in subprime mortgages, the crisis in that industry was a contributing factor to the County's own credit crisis.[30] Two of the insurers for several of the County's swap transactions were the Federal Guaranty Insurance Company ("FGIC") and the XL Capital Assurance Corporation ("XLCA"), both of whom had heavily invested in the subprime market.[31] This investment led to ratings downgrades for these bond insurers by Fitch Ratings Ltd. ("Fitch"), Moody's

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23. *Id.*; *see infra* Part III for a more detailed discussion of the types of financial products used by Jefferson County.

24. Complaint at 8, SEC v. Langford, No. CV-08-B-0761-S 8 (N.D. Ala. 2008), *available at* http://www.sec.gov/litigation/complaints/2008/comp20545.pdf [hereinafter SEC Complaint].

25. *Id.*

26. Karen Richardson, *Sweet Hedge Alabama: A County Defends Rate-Swap Strategy*, WALL ST. J., June 8, 2005, at C1.

27. *See id.*

28. AEI Transcript, *supra* note 13.

29. *Id.*

30. *See* JEFFERSON COUNTY, ALABAMA SEWER REVENUE WARRANTS, MATERIAL EVENT NOTICE 1-5 (Feb. 20, 2008) [hereinafter Feb. 20 Material Event Notice].

31. *See id.* at 1.

Investors Service, Inc. ("Moody's"), and Standard & Poor's Ratings Services ("S&P").[32] The downgrades impacted swap transactions the two companies had insured for Jefferson County and initiated possible events of default under the trust indentures.[33]

In addition to the ratings downgrades of the bond insurers, Jefferson County was dealt another blow when its own auction-rate securities failed auctions on February 13 and 14, 2008.[34] "[A]s a result of the failed auctions," the securities began to accrue interest "at the maximum auction rate allowed under the Trust Indenture."[35]

On February 25, 2008, warrants insured by FGIC were downgraded from "AA" to "A" by S&P.[36] On the same day, S&P lowered the ratings of the warrants insured by XLCA from "AAA" to "A-."[37] On February 26, 2008, Moody's downgraded the County's underlying rating on the warrants to "Baa3," resulting in an Additional Termination Event under each of the swap agreements.[38]

These ratings downgrades were the first of many.[39] Prior to the downgrades, ratings for Jefferson County's sewer debt were listed as "A3" and "A" by Moody's and S&P, respectively.[40] But 88 days later these ratings plummeted to junk bond status.[41]

Thus far, the County has been successful in negotiating with the counterparties and liquidity providers involved in its various swap transactions by entering into forbearance agreements, the most recent of which extends the County's obligations until

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32. *Id.* at 1-2.

33. *Id.*

34. *Id.*

35. *Id.*

36. JEFFERSON COUNTY, ALABAMA SEWER REVENUE WARRANTS, MATERIAL EVENT NOTICE 1 (Feb. 27, 2008).

37. *Id.* at 2.

38. *Id.* at 4.

39. *See* Material Event Notices dated Mar. 4, Mar. 11, Apr. 1, June 9, June 30, Sept. 22, and Oct. 28, 2008, *available at* http://jeffco.jccal.org/portal/page?_pageid=254,46650,254_46714&_dad=portal&_schema=portal.

40. AEI Transcript, *supra* note 13.

41. *Id.*; *see* MOODY'S, RATING DEFINITIONS, http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=rdef&subtopic=moodys%20credit%20ratings&title=US+Municipal+and+Tax-Exempt+Ratings.htm (last visited Feb. 22, 2010); STANDARD & POORS', UNDERSTANDING STANDARD & POOR'S RATING DEFINITIONS 1-6 (2009), http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,4,1204840817021.html#ID223 (providing definitions of individual issuer ratings and explanations of this methodology).

April 20, 2009.[42] It has not been as successful with the two bond insurance companies insuring many of its downgraded sewer Warrants. Syncora Guarantee Inc. (formerly XLCA, "Syncora") and FGIC, with The Bank of New York Mellon as Trustee, filed suit requesting the court to appoint an independent receiver for the purposes of: (1) managing the County's sewer system; (2) implementing modifications to the County's sewer rates and exploring other potential sources of revenue; (3) making sure any actions are in compliance with all applicable laws; and (4) assisting in an appropriate financial resolution to the matter as well as pursuing any valid claims.[43]

A full hearing on the case was originally scheduled for February 25, 2009,[44] but was changed to a status hearing, with a full hearing to be scheduled at a later date.[45]

II. FACTORS LEADING TO CURRENT FINANCIAL CRISIS

After examining the County's February 20, 2008 Material Event Notice,[46] the managing director of Swap Financial Group, Peter Shapiro, stated that the crisis in Jefferson County was "a text book example" of the myriad of things that can go wrong in the current national financial crisis.[47] He noted that the County had been hit hard by the crash of the auction-rate securities market and the bond insurance crisis, but that its current problems were essentially a result of the circumstances of the time, not by anything that it had done, further asserting that "[n]o one would have anticipated this."[48]

With all due respect to Mr. Shapiro, he is not entirely correct. While the exact circumstances in Jefferson County may

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42. Shelly Sigo, *Jefferson Co. Insurers, Trustee Urge Appointment of Receiver*, BOND BUYER, Feb. 20, 2009, at REGIONS 22.

43. SYNCORA GUARANTEE INC., PRESS RELEASE: SYNCORA GUARANTEE INC., FINANCIAL GUARANTY INSURANCE COMPANY AND THE BANK OF NEW YORK MELLON, AS TRUSTEE, SEEK APPOINTMENT OF A RECEIVER FOR JEFFERSON COUNTY SEWER SYSTEM (Sept. 16, 2008), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=198015&p=irol-newsArticle&ID=1197915&highlight [hereinafter Insurer Press Release]; *see* Complaint at 4, The Bank of N.Y. Mellon v. Jefferson County, Ala., No. CV-08-H-1703-S (N.D. Ala. 2008).

44. Shelly Sigo, *Special Master Ordered for Jeffco Sewers*, BOND BUYER, Nov. 20, 2008, *available at* http://www.bondbuyer.com/issues/117_223/-296624-1.html [hereinafter Sigo, *Special Master Ordered*].

45. Shelly Sigo, *Judge in Jefferson County Case Puts Off Holding a Full Hearing*, BOND BUYER, Feb. 24, 2009, at 367 REGIONS 3.

46. *See* Feb. 20 Material Event Notice, *supra* note 30.

47. Shelly Sigo, *Alabama County Issues New Disclosure Notice; Outlines Auction Failures, Impact on Swaps*, BOND BUYER, Feb. 22, 2008, at 363 MARKET NEWS 1.

48. *Id.*

not have been predictable, it should have been clear to anyone who was willing to look closely that Jefferson County's financial condition was more than a little problematic.[49] The reasons Jefferson County currently finds itself in this precarious position are both general and distinct—general to the industry as a whole because of the global credit crisis, and distinct to Jefferson County alone. This section looks at those distinct factors that have led to this crisis: (1) government structural factors; (2) incompetence; and (3) corruption.

A. *Government Structural Factors*

1. No Home Rule Powers

> Municipal corporations owe their origin to, and derive their powers and rights wholly from the Legislature. It breathes into them the breath of life, without which they cannot exist. As it creates, so it may destroy. If it may destroy, it may abridge and control.[50]

The above principle is known as "Dillon's Rule," and was uttered in 1868 by Iowa Supreme Court Judge John F. Dillon.[51] The rule essentially states that the only powers that local governments are allowed to exercise are those that are specifically conferred upon them by a state government.[52] In other words, Judge Dillon was <u>not</u> a proponent of home rule for municipal governments.

"Home rule" is defined as "[a] state legislative provision or action allocating a measure of autonomy to a local government, conditional on its acceptance of certain terms."[53] The majority of states give home rule powers to municipalities and other local governmental entities.[54] Alabama is one of only two states—the other being Vermont—which does not allow its municipalities to have this power.[55]

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49. *See* Richardson, *supra* note 26.

50. Joe A. Summers, *Missing: Local Democracy*, *in* A CENTURY OF CONTROVERSY: CONSTITUTIONAL REFORM IN ALABAMA 68, 68 (Bailey Thomson ed., 2002) (quoting "Dillon's Rule").

51. *Id.*

52. *Id.*

53. BLACK'S LAW DICTIONARY 802 (9th ed. 2009).

54. Jim Williams & Randolph Horn, *Local Self Government in Alabama*, 33 CUMB. L. REV. 245, 249 (2002-2003).

55. *Id.*

The State of Alabama created municipal governments in the early 1900s by special legislative charter, which charter gave municipalities very limited discretion with regard to financial and legislative matters.[56] Alabama follows "Dillon's Rule" "more tenaciously" than other states who only "subscribe to [the] Rule to some degree".[57] Under the Alabama constitution, counties and other municipal governments are not given general powers that they can use to perform many ordinary local government functions.[58]

Because the counties have no home rule authority, they must operate through the "slow, cumbersome routes of constitutional amendment and local legislative act."[59] Therefore, in addition to its state legislative duties, the legislature must contend with local bills and amendments, which can amount to nearly half of the workload for the legislature.[60]

Because Alabama does not grant home rule powers to municipalities, counties and other local governmental units must seek the approval of the legislature "for virtually everything they do."[61] This practice is called "legislative courtesy."[62] Under this system, any legislation relating to individual counties must be approved by the legislators from the local delegation which, in the case of Jefferson County, is composed of 26 members.[63] If the local delegation approves the bill, then it will be adopted by the House and Senate.[64]

Amending the constitution is practically standard operating procedure in Alabama.[65] There are nearly 700 amendments, with approximately 75% dealing with matters specific to individual cities and counties.[66]

This situation has been a problem for Jefferson County in trying to tackle its current fiscal crisis.[67] At one point, Jefferson

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56. *Id.* at 257-58.

57. Summers, *supra* note 50, at 68.

58. Albert P. Brewer, *Encyclopedia of Alabama: Home Rule*, Apr. 17, 2007, http://www.encyclopediaofalabama.org/face/Article.jsp?id=h-1153.

59. Summers, *supra* note 50, at 69.

60. *Id.*

61. Shelly Sigo, *Alabama Gov. Bob Riley Nixes Special Session on Jefferson County*, BOND BUYER, Aug. 7, 2008, at 365 SOUTHEAST 8.

62. Summers, *supra* note 50, at 69-70.

63. Shelly Sigo, *Jefferson County Commissioner Faults Legislators for Opposing Crisis Plan*, BOND BUYER, Oct. 10, 2008, at 365 THE REGIONS 24 [hereinafter Sigo, *Opposing Crisis Plan*].

64. Summers, *supra* note 50, at 69-70.

65. *See id.* at 69.

66. *See id.*

67. Sigo, *Opposing Crisis Plan*, *supra* note 63.

County officials had formulated a restructuring plan in conjunction with many of its creditors to deal with the County's outstanding debt.[68] However, that plan required local legislative approval, and such approval was withheld.[69] "'Our archaic, outdated Alabama Constitution gives the Jefferson County legislative delegation absolute and total authority and control over Jefferson County,' [Bettye Fine] Collins, [president of the Jefferson County Commission], said . . . 'Sadly the Jefferson County legislative delegation wants all the power and none of the accompanying responsibility.'"[70]

2. Structure of Jefferson County Commission

> It is hard to imagine a structure less suited to efficient and accountable administration than is county government in Alabama. Its authority is fragmented among county-level offices filled by popular vote, creating a government of elected equals with no one in charge.[71]

The Jefferson County Commission is composed of five commissioners elected from five separate single-member districts.[72] As a result, the County has no leader who is elected countywide, "no countywide leader who has the interest of the whole government in mind . . . nobody who can raise a consensus, nobody who can develop a mandate."[73] Therefore, there is no official who, by virtue of his or her elected office, can lead the entire county in the ways that are necessary to deal with a crisis such as the one currently facing Jefferson County.[74]

In addition, each County commissioner is assigned supervisory authority and control over one of the following departments: Finance and General Services; Roads and Transportation; Environmental Services (which has responsibility for the sewer system); Health and Human

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68. Barnett Wright, *Jeffco to Reject Lenders' Tax Plan; Wall Street Creditors Want to Tap Revenues*, BIRMINGHAM NEWS, Sept. 12, 2008, at 1A.

69. *See id.*

70. Sigo, *Opposing Crisis Plan*, *supra* note 63.

71. Summers, *supra* note 50, at 74.

72. Jefferson County, Alabama, Resolution of Organization (Nov. 14, 2006), http://jeffco.jccal.org/pls/portal/docs/PAGE/FINANCE_PAGE_GROUP/INVESTOR_RELATIONS/TAB46744/RESOLUTION%20OF%20ORGANIZATION%20-%2011-14-06.PDF [hereinafter Organization Resolution].

73. AEI Transcript, *supra* note 13.

74. *Id.*

Services; and Information Technology.[75] According to Larry Lavender, a member of the House Financial Services Committee, "[o]ne runs the sewers, one runs the finances, one runs the public safety . . . . And so you end up without anybody to provide the real leadership that's necessary to deal with a serious problem such as Jefferson County had."[76]

B. *Incompetence*

> Neither I nor anybody in the Jefferson County commission — or for that matter, I'm not even sure that the JPMorgan people that we deal with — really understand how swaps are priced in the global financial market.[77]

The above quote is from Bill Slaughter, who served as bond counsel to the County.[78] If the attorney advising the County on these transactions didn't understand them, what good was his advice? However, Mr. Slaughter was not alone in his sense that few people understood the details of the transactions.[79] Randy Wilhelm, a consultant for Bank of America on two swap contracts for the County stated, "[JPMorgan banker] Charles LeCroy knew a lot about it, and there wasn't any scrutiny that anybody around here could give because they didn't have the level of knowledge that he had."[80]

These statements beg the question of whether Jefferson County should have been involved in these deals in the first place. Municipalities that do not have the proper financial knowledge should not divulge themselves into complicated municipal areas that are "very difficult to value."[81]

In addition to the County's difficulty in understanding the complicated financial transactions in which it was involved, the County also had problems balancing its books.[82] After it was unable to finish the 2006 interim financial statements on time, the County hired an outside accountant.[83] When that accountant

75. Organization Resolution, *supra* note 72.

76. AEI Transcript, *supra* note 13.

77. Braun, *supra* note 2, at 58 (quoting Bill Slaughter, bond counsel for Jefferson County).

78. *Id.*

79. *See id.* at 56.

80. *Id.*

81. *Id.* at 59 (quoting Gary Gray, a visiting professor of finance at Pennsylvania State University's Smeal College of Business in University Park, Pennsylvania).

82. AEI Transcript, *supra* note 13.

83. *Id.*

couldn't balance the books, a new SAP financial management system was installed—and failed the first time the County tried to use it.[84] Managing the situation has been a "total debacle."[85]

Jefferson County's crisis is a prime example of "how not to run a municipal government."[86] First, the County's sewer projects were planned, designed, and overseen by non-professionals.[87] There was no one with any professional management experience in charge.[88] A 2003 BE&K Engineering report found that the County wasted "hundreds of millions of dollars by overbuilding treatment plants, overpaying contractors for sewer rehabilitation and using inexperienced managers to oversee the effort."[89]

Second, in addition to the improvements required to be made under the Consent Decree, the County planned separate sewer expansion projects projected to cost approximately $500 million.[90] The County spent as much as $242 million on these programs before they were cancelled in 2002.[91] Even with the cancellations, Jefferson County still had a problem. Because there were no cancellation clauses in the contracts, the County was still obligated to pay $18 million in fees.[92]

Third, the County failed to exercise control over both project spending and the contractors performing the work.[93] This situation "created a domino chain of temptation, greed, corruption and criminal charges."[94] BE&K's report showed that Jefferson County did not hire its engineers and consultants based on "a qualification-based selection process," as is usual for most large public works projects.[95] The same report noted that "[i]f that program had existed in Jefferson County, most local engineers would have had trouble qualifying."[96]

As a final blow, in September 2006, with billions of dollars spent and 90% of the sewer improvements completed, the County

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84. *Id.*
85. *Id.*
86. Hansen, *supra* note 11.
87. *Id.*
88. *See id.*
89. *Id.*
90. Eric Velasco, *The Sewer Scandal Cost: $336,000,000*, BIRMINGHAM NEWS, July 1, 2007, at 1A.
91. *Id.*
92. *Id.*
93. Hansen, *supra* note 11.
94. *Id.*
95. Velasco, *supra* note 90.
96. *Id.*

was fined $339,000 by the EPA because of "continuing sewage overflows."[97]

C. *Corruption*

> Thus far, we've had 21 people convicted. Two county commissioners, the head of the environmental services division, the deputy head of the environmental services division, contractors, others, the list goes on.[98]

There must be something in the water. What else explains the 21 indictments on federal charges of bribery and conspiracy of County officials, personnel, and contractors associated with the sewer system improvements, all of which resulted in guilty pleas or convictions?[99]

Two more have recently been added to the list, including Larry Langford, the former President of the Jefferson County commission and now mayor of Birmingham.[100] On November 25, 2008, the U.S. Attorney issued a 101-count indictment against Mayor Langford, lobbyist Albert LaPierre and securities dealer William Blount, asserting that the three were involved in what she described as a "classic pay-to-play scheme."[101] The charges included "conspiracy, bribery, fraud, money laundering, and filing false tax returns in connection with a long-running bribery scheme related to bond and other financial transactions in Jefferson County." [102]

Mayor Langford has even more problems. The SEC has filed a 6-count complaint against him and Blount alleging violations of several securities laws in connection with the 2003 and 2004 bond financings.[103]

Previously, in 2004, the IRS sent a letter to the County informing it of an investigation it was launching to determine if the County violated federal tax laws in connection with the

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97. *Id.*

98. AEI Transcript, *supra* note 13.

99. Velasco, *supra* note 90; *see also* Bob Sims, *The Timeline: Sewer Construction and Corruption*, AL.COM, Sept. 24, 2008, http://blog.al.com/bn/2008/09/the_timeline_sewer_constructio.html (detailing the timeline of events related to the scandal through September 2008).

100. Shelly Sigo, *Langford, 2 Others Indicted; Charges Stem From Jefferson Co. Deals*, THE BOND BUYER, Dec. 2, 2008, at 365 NEWS 1.

101. *Id.*

102. *Id.*

103. SEC Complaint, *supra* note 24, at 33-39.

various sewer financings.[104] Charles Anderson, manager of field operations for the IRS's tax-exempt-bond office in Baltimore explained that the IRS typically will look at the fees involved in municipal swap transactions because they are often a cover for additional fees improperly paid to the banks or to public officials.[105] Anderson mentioned that such a swap can serve to mask a kickback, perpetrated through the use of a regulated payment and an unregulated payment; when money is transferred to the unregulated payment and a covert agreement is made on the regulated payment, regulations are no longer heeded.[106]

III. DERIVATIVES

> I think that in terms of understanding derivative finance, there are five people who understand [it], they are all locked in a basement on Wall Street and they don't ever let them out. So I don't think there's anybody who understands it really on the streets.[107]

Derivatives are financings that involve two parties in a very complex arrangement to make payments to each other.[108] The obligations between the two parties are generally netted together so that only one payment is made.[109] Very little, if any, investment is required to enter into these types of agreements.[110] Governments are the primary users of derivatives and they enter into the agreements so that their borrowing costs can be reduced—by "locking-in prices," they can therefore lower the possibility of changing prices.[111]

The value of a derivative is "derived" from another, underlying, security.[112] The "underlying" can literally be

104. Braun, *supra* note 2, at 55.

105. *Id.*

106. *Id.*

107. AEI Transcript, *supra* note 13.

108. GOVERNMENT ACCOUNTING STANDARDS BOARD (GASB), ACCOUNTING AND FINANCIAL REPORTING FOR DERIVATIVES INSTRUMENTS – A FEW BASIC QUESTIONS AND ANSWERS, (2008), http://www.gasb.org/project_pages/Derivatives_Final_Statement_Fact_Sheet.pdf.

109. *Id.*

110. *Id.*

111. *Id.*

112. JUDY WESALO TEMEL, THE FUNDAMENTALS OF MUNICIPAL BONDS 224 (The Bond Market Association, John Wiley & Sons 5th Ed., 2001) (1981).

anything for which there is a market.[113] Underlyings are valued according to market forces and are therefore significantly affected by its changes.[114] Derivatives are then valued according to the state of its underlyings.[115]

This section examines the types of financings employed by Jefferson County, looking first at the financings as they are generally understood, and then looking at Jefferson County's use of these financial vehicles. This section will then look at systemic problems within the industry, such as the lack of sufficient regulation of the derivative industry and the lack of competitive bidding, factors which have played a major role in Jefferson County's current dilemma.

A. *Auction Rate Securities*

1. Definition of "Auction Rate Securities"

> Auction Rate Securities ("ARS") are clever creations of investment bankers that enable borrowers to incur long-term debt at short-term rates and lenders to obtain the safety and liquidity of money markets at a higher return. As could be expected with clever creations of investment bankers . . . the incredible benefits conferred on the issuers of, and investors in, these instruments turn out to be too good to be true.[116]

Municipal auction rate securities ("ARS") are variable rate municipal bonds whose rates are re-set at periodic auctions usually occurring every 7, 14, 28 or 35 days.[117] They involve long-term debt, with maturities anywhere from "five years to perpetuity."[118]

Auction procedures are set forth in the offering documents and generally require that one or more broker-dealers solicit bids

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113. Norman Menachem Feder, *Deconstructing Over-The-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 681-82 (2002).

114. *Id.*

115. *Id.*

116. Glenn S. Gitomer, *Auction Rate Securities: A Crisis Foretold, in* SECURITIES ARBITRATION 2008: EVOLVING AND IMPROVING, at 361 (PLI Corp. Law & Practice, Course Handbook Series No. 14310, 2008).

117. SECURITIES INDUSTRY FINANCIAL MARKETS ASSOCIATION, SEC No-Action Letter (Mar. 14, 2008), *available at* http://www.sifma.org/capital_markets/docs/SEC—ARS-Letter.pdf [hereinafter SIFMA No-Action Letter].

118. *Id.*

from investors for orders of the securities.[119] Once orders have been placed, the auction agent ranks them by rate.[120] If investors purchase all the shares available for at least the minimum acceptable rate, the "clearing rate," that is, the lowest rate at which purchasers are willing to buy all the securities available for sale in the auction,[121] is established; the clearing rate then applies to the securities until the next auction.[122]

A failed auction occurs if the agent fails to receive an acceptable number of orders that are at or below the maximum rate for the total par amount of the securities at auction.[123] In such an event, the interest rate is set at the maximum rate, "which is often a multiple of a reference Rate, such as LIBOR[124] or an index of Treasury securities . . . [or] an absolute number such as 15%."[125] This "fail rate" is usually much higher than current market rates.[126]

In such cases, bondholders must continue to hold the ARS[127] until the sooner of (1) the next successful auction or (2) either the maturity of the ARS or the early call of the same.[128] If the fail rate for the securities is at an interest rate that is the same or lower than that of comparably rated long-term bonds, the ARS will have lost the short-term liquidity expected to be gained from the use of the periodic auctions.[129] At this point, an investor is left holding "long-term credit risks at unacceptable interest rates."[130]

Before the current financial crisis, investment banks would often intercede to prevent a failed auction and buy the ARS.[131] While many investors were aware of this practice, most were not aware of the extent to which it was being used.[132] Dealers were

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119. SECURITIES INDUSTRY FINANCIAL MARKETS ASSOCIATION, BEST PRACTICES FOR BROKER-DEALERS OF AUCTION RATE SECURITIES 6 (2007), http://www.sifma.org/services/pdf/AuctionRateSecurities_FinalBestPractices.pdf [hereinafter BEST PRACTICES].

120. *Id.* at 6.

121. *Id.* at 6-8.

122. Gitomer, *supra* note 116, at 362.

123. BEST PRACTICES, *supra* note 119, at 9.

124. "LIBOR" is an acronym for the London Inter-Bank Offered Rate. This is the interest rate that banks charge each other as well as a standard used to price many types of derivatives. FRANCESCA TAYLOR, MASTERING DERIVATIVES MARKETS 408 (3d ed. 2007).

125. BEST PRACTICES, *supra* note 119, at 9.

126. SIFMA No-Action Letter, *supra* note 117.

127. *Id.*

128. Gitomer, *supra* note 116, at 362-63.

129. *Id.* at 363.

130. *Id.*

131. *Id.* at 364.

132. *Id.*

essentially "propping up" the auctions, "[lulling investors] into a false sense that their ARS could easily be liquidated at any auction interval and in the meantime enjoy[ing] a competitive return."[133]

2. Collapse of Auction Rate Securities Market

In early 2008, the credit market started to crumble, and banks that had been hit hard by the subprime mortgage crisis stopped buying ARS.[134] By the middle of February, auctions of the securities "came to a grinding halt."[135] Investment banks failed to step into the role of "buyers of last resort," thus dooming the auctions to fail.[136] Holders of ARS were now stuck with securities that no one wanted to buy.[137]

Adding to the problem was the "dramatic implosion" of municipal bond insurers.[138] Even though insurance is typically thought of as a low-risk business, in recent years the insurance companies have began to delve into other areas—namely subprime mortgages and other structured debt instruments.[139] When those markets cratered, the insurers faced, among other things, possible bankruptcy.[140] Soon bond insurers began to see their "AAA" ratings downgraded,[141] which further impacted the securities they were insuring.[142]

Many issuers of auction rate securities obtained bond insurance to act as a guaranty of payment and to insure the securities until they were fully paid.[143] This placed the bond insurers in a further bind and had a disastrous affect on the industry.[144] Even Financial Guaranty Assurance, Inc. ("FSA"), which seemed to weather the storm, is set for downgrade if its

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133. *Id.*

134. Gitomer, *supra* note 116, at 364.

135. *Id.*

136. *Firm Settles Own Bond Case $19.5 Billion in Auction Securities Involved*, BIRMINGHAM NEWS, Aug. 8, 2008, at 1C [hereinafter *Firm Settles*].

137. *See* Gitomer, *supra* note 116, at 364.

138. John E. Petersen, *Mayhem and the Markets*, GOVERNING, June 2008, at 40, 43, *available at* http://www.governing.com/node/842/.

139. *See id.*

140. *Id.*

141. *See id.*

142. *See id.*

143. Jeffrey T. Chappelle, Credit Enhancement 30-15 (2008) (unpublished handout from the National Association of Bond Lawyers 2008 Bond Attorneys' Workshop, on file with the HBTLJ) [hereinafter CREDIT ENHANCEMENT].

144. *Id.*

proposed acquisition by Assured Guaranty Ltd. is not completed.[145]

The affect of the crisis on the bond insurers further devastated the ARS market.[146] This resulted in failed auctions, with borrowers having to pay exorbitant interest rates.[147] In addition, as borrowers desperately attempted to refund or restructure their auction rate bonds, they were not participating in new issues of securities, further damaging the markets.[148]

B. *Swaps*

1. Definition of Swaps

> [T]he term "swap agreement" means any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product . . . .[149]

In an interest rate swap, two parties legally agree to exchange cash flows which are derived by underlying "equities, debt obligations, commodities or other financial instruments."[150] The simplest and most common interest rate swaps (called "plain-vanilla" swaps) are agreements in which one party agrees to pay a fixed interest rate using a "notional amount,"[151] while the other party agrees to pay a floating rate, which is typically based on LIBOR.[152] The diagram below depicts a plain-vanilla interest rate swap.

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145. *S&P: Financial Security Assurance Inc. (FSA) Remains on CreditWatch Negative*, BOND BUYER, Dec. 24, 2008, http://www.bondbuyer.com/news/-297767-1.html.

146. CREDIT ENHANCEMENT, *supra* note 143, at 30-19.

147. *Id.*

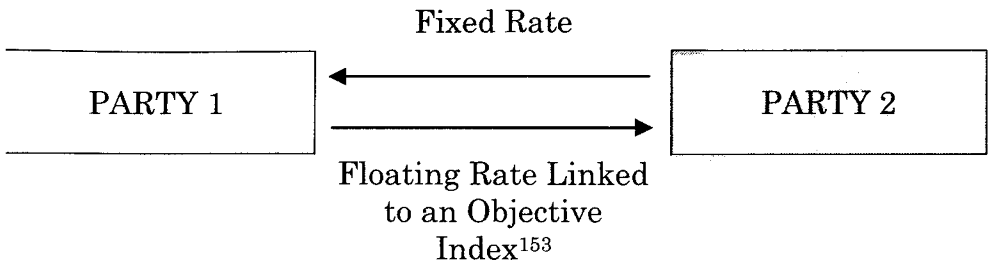
148. *Id.*

149. Gramm-Leach-Bliley Act of 1999 § 206(b), 15 U.S.C. § 78 note (2001).

150. Todd L. Cooper, Introduction to Swaps and Related Transactions 23-1 (2008) (unpublished handout from the National Association of Bond Lawyers 2008 Bond Attorneys' Workshop, on file with HBTLJ) [hereinafter Intro to Swaps].

151. A notional amount is the "stated principal amount . . . on which the swap is based." TEMEL, *supra* note 112, at 250.

152. S. Lawrence Polk & Bryan M. Ward, *A Guide to the "Regulatory No Man's Land" of Over-the-Counter Interest Rate Swaps*, 124 BANKING L.J. 397, 399 (2007).



While the most common form of interest rate swap is a floating-to-fixed rate agreement, there are also fixed-to-floating and floating-to-floating (basis) swaps as well.[154] With a fixed-to-floating swap (the primary type employed by Jefferson County), an issuer makes payments at a variable rate of interest, based on LIBOR or some other objective index, and receives payments from the counterparty at a fixed rate of interest.[155] These payments are calculated based on a notional principal amount, although there is no actual exchange of principal involved.[156]

Methods of determining the floating rate to be paid by the issuer vary. A "floating rate asset" belonging to the issuer may be used, as can another similar, although not identical, method of measurement.[157] The notional amount of the swap can be equal to the total principal amount of the bonds or some lesser amount.[158] If the swap agreement involves all the bonds in a given issue, the notional amount and the bond principal amount may amortize over the same period.[159] Also, the maturity dates of the bonds and the swap do not have to be the same; the swaps may mature at the same time as the bonds or at an earlier date.[160]

One reason an issuer may wish to enter into a fixed-to-floating swap is the possibility of incurring fewer borrowing costs by obtaining a lower "all-in" floating rate than it would otherwise be able to get if it issued the debt directly.[161] Another reason to use this type of swap is to use it as a hedge against dramatic interest rate changes.[162] In a period of short-

153. INTRO TO SWAPS, *supra* note 150, at 23-1.
154. *Id.* at 23-1 to -5.
155. *Id.* at 23-3 to -4.
156. *Id.* at 23-4.
157. *Id.* at 23-5.
158. *Id.*
159. INTRO TO SWAPS, *supra* note 150, at 23-5.
160. *Id.*
161. *Id.*
162. *Id.*

term interest rate declines, the decrease in the floating rate swap obligation compensates for the reduction in earnings on the issuer's floating rate assets; the reverse happens in a period of rising interest rates.[163]

2. Risks of Swaps

The primary risk for an issuer entering into a swap agreement is that interest rates will move in the counterparty's direction.[164] One party will always be "in the money"—receiving payments under the swap—while the other party will always be "out of the money"—obligated to pay under the swap.[165] The fact that the interest rate exposure of a party to the agreement is neither fixed nor predictable can create problems down the road.[166]

"Basis risk" is another possible problem for those involved in floating-to-fixed interest rate swaps.[167] Basis risk can occur if the floating rate index used to determine payments under the swap is different from that used for the underlying bonds.[168] It is essentially "the risk that the relationship between the floating rate on the tax-exempt bonds (e.g., an issuer's individual 7-day rate) and the floating rate on the swap (e.g., LIBOR or the SIFMA index) may change materially over the life of the swap."[169] An issuer generally enters into a swap with the assumption that the floating bond payment and the floating swap payment will "match up and cancel each other out."[170] However, if this does not prove to be the case, the issuer could end up with a loss.[171] If both the payment under the swap and the payment on the underlying bonds are calculated based on the same index, this problem will be avoided.[172]

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163. *Id.*
164. Polk, *supra* note 152, at 401.
165. *Id.*
166. *Id.*
167. INTRO TO SWAPS, *supra* note 150, at 23-3.
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. *Id.*

C. *Jefferson County Financings*

1. Swaps and Auction-Rate Securities

a. Swaps

> Jefferson County, with a population of 660,000, has $5.8 billion in swaps on its books – the most of any county in the U.S. and about $1 billion less than New York State, the largest user of municipal swaps in the U.S., according to Bloomberg data.[173]

Prior to entering into the 1996 Consent Decree, Jefferson County had $301 million in sewer debt.[174] After signing the Consent Decree, the County refinanced its existing sewer debt and issued $300 million in new debt, more than doubling its sewer debt to $632 million.[175] The County issued additional debt in 1999 and 2001, raising total sewer debt to $1.8 billion, and then issued an additional $1 billion in sewer debt in 2002.[176] Up to this point, the County had 68% of its sewer debt primarily in fixed-rate municipal bonds.[177]

The only thing unusual about these early Jefferson County sewer financings was their duration of 40 years, which was 10 years longer than the traditional 30-year maturity for bonds.[178] The County was taking advantage of a new state law allowing such extended maturity schedules.[179] In fact, the law was passed at the behest of the County after it concluded that the sewer system improvements would take much longer to complete and pay for than the traditional 30 years for bond financings.[180]

In addition to extending the maturity of the obligations, the County also used "capitalized interest over the next three years" for the purpose of increasing sewer rates over a 3-year period, instead of allowing the rates to significantly rise in a single year.[181] Since the revenues from the sewer system went to pay

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173. Braun, *supra* note 2, at 55.
174. Hansen, *supra* note 11.
175. *Id.*
176. *Id.*
177. *Id.*
178. Christopher McEntee, *A Big and Rare Borrowing: Alabama Sewer Deal Will Go Out 40 Years*, BOND BUYER, Feb. 18, 1999, *available at* http://www.bondbuyer.com/news/-107942-1.html.
179. *Id.*
180. *Id.*
181. *Id.*

the rapidly growing debt on the improvements, this allowed the County to "spread the cost of the improvements over a growing base of ratepayers."[182] Also, the County anticipated that, as more users moved to the area and joined the system, more revenues would be generated for future years.[183]

There were several disadvantages to the County's extension. First, the interest portion on the debt would increase, a situation which would raise a red flag for rating agencies that there may be a problem in the future.[184] Second, Moody's already downgraded the County's underlying debt to Baa1 because of the reduced future financial flexibility caused by the County's "backloading" of its debt.[185] Third, there were already concerns as far back as 1999 about additional borrowing by the County.[186]

The County's practice of using fixed-rate financings changed in late 2002 and 2003, when Jefferson County refinanced the majority of its existing fixed-rate sewer debt with auction-rate securities and variable interest rate bonds, including three interest rate swaps.[187] The County would now have 94% of its total $3.2 billion sewer debt in "synthetically fixed interest rate bonds."[188]

The three swap contracts entered into by the County on October 23, 2002 "were money losers from the start."[189] On the date of purchase, on paper the derivatives were already showing a $22 million loss.[190] The swap agreements required that the County pay the banks $383,728,268 at a fixed 3.92 percentage rate over the course of the contract—a 38-year period.[191] The banks, on the other hand, were required to pay the County $361,552,581 over the same 38-year period at an interest rate 33% below LIBOR![192]

The County chose JPMorgan to handle the refinancing of the $2.1 billion sewer debt with interest rate swaps.[193] The County was acting on advice from JPMorgan banker, LeCroy, who

182. *Id.*
183. *See id.*
184. McEntee, *supra* note 178.
185. *Id.*
186. *Id.*
187. Hansen, *supra* note 11.
188. *Id.*
189. Braun, *supra* note 2, at 58.
190. *Id.*
191. *Id.* "In other words, if Libor were 3 percent, the bank would pay the county a rate of 2 percent." *Id.* at 57.
192. *Id.*
193. *Id.* at 54.

advised the commissioners that buying swap contracts could protect the County against higher interest rates on its variable-rate bonds.[194] Under the contract, the County agreed to pay a 3.678% fixed rate of interest to JPMorgan, with JPMorgan paying "a rate based on the Bond Market Association Municipal Swap Index through May 1, 2004."[195] For the remainder of the contract—again, 38 years—the bank would pay a rate of 33% below LIBOR.[196] JPMorgan made considerable profit on these deals, pocketing $4.6 million when they sold the bonds and another $20 million in fees for handling the swaps.[197]

Another problem for the County was that it entered into these financings with a debt service coverage ratio of 1:1.[198] As noted by Larry Lavender, ". . . at the time they did these things, when the rates were at the lowest they're ever going to be, the money that was available in the fund to pay debt service was exactly equal to the amount of money necessary to pay that debt service."[199] Therefore, the County had no cushion—if the rates changed, there were no funds available to pay the difference.[200] When the rates went up, the County found itself in an even worse situation than it had been in before.[201]

Jefferson County entered into these agreements with hopes of paying low interest rates on the debt over the next 40 years.[202] However, the "interest rates did the one thing that JPMorgan's LeCroy said they wouldn't do: They declined."[203]

Jefferson County had sewer debt of $3 billion with a notional swap value of $1.4 billion in November 2002.[204] Today, however, the County has sewer debt of $3.2 billion, as well as $4.6 billion in other long-term County debt.[205] It is the notional amount of the swaps on the sewer debt—$5.4 billion—that is staggering.[206] This current trend of "having more notional value than the actual amount of bonds appears unique in the United States."[207]

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194. *Id.* at 57-58.
195. Braun, *supra* note 2, at 57-58.
196. *Id.*
197. *Id.*
198. AEI Transcript, *supra* note 13.
199. *Id.*
200. *Id.*
201. *See id.*
202. Braun, *supra* note 2, at 57-58.
203. *Id.* at 54.
204. Hansen, *supra* note 11.
205. *Id.*
206. *Id.*
207. *Id.*

The situation today looks dire for Jefferson County. The rapidly increasing amount of interest payments now owed to the various financial entities involved in the swaps is astonishing. For instance, in October 2008 the County owed $250 million in interest.[208] The next month, the figure rose to $439 million.[209] With interest rates plunging further and further, the County owed a staggering $735 million in interest and penalty payments as of December 2008.[210] So large a figure further complicates negotiations with banks and other creditors to come up with a settlement.[211] Ironically, the same devices whose purpose it was to protect the County from escalating costs may very well be the devices which send it into bankruptcy.[212]

b. Auction Rate Securities

From the County's total sewer debt, $2.2 billion of it is wrapped up in auction-rate securities.[213] On February 13 and 14, 2008, the securities were unable to attract a bidder and consequently failed.[214] Since that time, all of the County's debt auctions have failed.[215]

When the auctions failed, the County's interest payments to the bondholders rose to as much as 10% in some instances.[216] This cost the County an additional $700,000 per week in interest payments.[217] One example of this can be seen in the interest rate on the $147.2 million Series 2003-B-1-3 bonds, whose rate rose from 3.75% in the summer of 2007 to 7.70% in August 2008.[218] In light of its financial situation, the County has been withholding the interest payments that are due on these securities.[219]

The County blames its current situation on the ratings downgrades of financial insurers FGIC and XLCA/Syncora, which together insured nearly $2 billion of the County's auction-

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208. Barnett Wright, *Jeffco's Cost to End Swap Deals: $735 Million Amount Could Complicate Debt Settlement Talks*, BIRMINGHAM NEWS, Dec. 16, 2008, at 1A.

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.*

213. *Firm Settles*, *supra* note 136.

214. *See id.*

215. Barnett Wright, *Sewer Bond Interest Soars Payments Increase $700,000 Per Week*, BIRMINGHAM NEWS, Apr. 27, 2008, at 1A [hereinafter Wright, *Sewer Bond Interest Soars*].

216. *Firm Settles*, *supra* note 136.

217. *Id.*

218. Russell Hubbard & Barnett Wright, *Auctions Fizzle, Banks Profit Government Loses but Fees Pocketed*, BIRMINGHAM NEWS, Apr. 26, 2008, at 1A.

219. *See* Wright, *Sewer Bond Interest Soars*, *supra* note 215.

rate securities.[220] As a result, investors were hesitant to invest, thus causing the auctions to fail.[221] The price of this failure has been an extremely high one for the County.[222]

2. Rising Sewer Rates

Because revenues from the sewer system are designated to pay for the costs of the sewer improvements, Jefferson County residents have had to face another problem—an increase in sewer fees of 329%![223] In 1997, shortly following the approval of the consent decree, the County arranged for annual sewer rate increases to cover additional costs of the improvements.[224] These increases are automatic and occur without the County commissioners having to vote on them.[225] The increases are "based on a complex formula that estimates how much revenue the county needs for the coming year to meet financial obligations on its $3.2 billion sewer debt."[226]

The increased cost in 2008 was $125 million.[227] However, because of much higher interest costs and penalty payments on the sewer debt in 2009, the current estimate is $460 million in debt payments.[228] This would require a rate increase of 392%, which would increase the average sewer bill from $63 a month to over $300 a month.[229] Faced with such a dramatic increase in the rate, the County commission moved to suspend the automatic sewer rate increases that would have gone into effect on January 1, 2009.[230]

3. Negotiated Bidding

According to Bloomberg Markets, "Jefferson County is an example of what can go wrong for borrowers across the U.S. who avoid competitive bidding."[231] Using a few hand-picked Wall

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220. *Id.*
221. *Id.*
222. *See id.*
223. Shelly Sigo, *Alabama Rep. Eyes Safeguards; Urges New Agency After Jefferson Woes*, BOND BUYER, Apr. 10, 2008, at 364 SOUTHEAST 1.
224. Brett J. Blackledge & Vickii Howell, *Third of Sewer Costs Not Ordered by Court*, BIRMINGHAM NEWS, June 10, 2001, at 1A.
225. Thomas Spencer, *County Weighs Prospect of $300 Sewer Bills Automatic Rate Increase at Issue*, BIRMINGHAM NEWS, Dec. 11, 2008, at 1A.
226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*
230. Barnett Wright, *No Sewer Rate Increase on Tap*, BIRMINGHAM NEWS, Dec. 24, 2008, at 1B.
231. Braun, *supra* note 2, at 52.

Street firms, the County financed its sewer improvements with "derivatives – complicated, unregulated and occasionally disastrous financial contracts whose values vary with the price of underlying securities or indexes."[232]

These firms were led by JPMorgan, whose fees were $45 million, an amount nearly two times the usual fee for these types of derivative transactions.[233] JPMorgan arranged and managed $3.36 billion of derivative deals on the County's new sewer bonds without competitive bidding.[234] After a decade and billions of dollars of financing, the County has yet to go out for competitive bids on its sewer financing work.[235]

Jefferson County is not alone in its avoidance of competitive bidding for financial services.[236] In 2005, Bloomberg Markets reported that 8 of 10 bond sales by state and local governments were done through negotiated deals rather than competitive bidding.[237]

Although state and local governments customarily employ the competitive bidding process in buying other supplies or services, they do not tend to do so with their public finance services.[238] Bloomberg Markets noted, "[o]f the $360 billion in debt sold by U.S. municipalities in 2004, 81 percent was arranged without competitive bidding. That's a 27 percent increase from 1974 . . . ."[239]

Negotiated, non-competitive deals involve private talks between the banker(s) and the issuer (e.g., the governmental entity).[240] The purpose of these talks is to discuss the proposed public financing and to negotiate the interest rate and price.[241] Contrast this with a competitive sale where the issuer posts a public notice inviting bids from banks and awards the transaction to the bank with the lowest bid.[242]

Bankers then charge a fee for negotiating the transaction. These fees are treated similarly to points on a mortgage loan.[243]

232. *Id.*
233. *Id.* at 52, 54.
234. *Id.* at 54.
235. *Id.*
236. *Id.*
237. Braun, *supra* note 2, at 52, 54.
238. *Id.* at 54.
239. *Id.*
240. *Id.*
241. *Id.*
242. *Id.*
243. Braun, *supra* note 2, at 58.

Treated like mortgage points, the swap fees "are added into the cost of the loan and amortized over its entire term."[244]

As noted above, Jefferson County was paying triple the amount of bankers' fees that are normally charged for such transactions.[245] The County was paying an exorbitant 19-20 basis points[246] in fees for its sewer refinancings between 2002 and 2004.[247] However, at about the same time, JPMorgan won a competitive bid on a $311.7 million interest rate swap for the New York Government Assistance Corp. and charged only 6 basis points.[248]

Ironically, in 1996, 4 County commissioners, three of whom would later be convicted of bribery, argued the merits of negotiated bidding.[249]

D. *Proposed Solutions*

> The numbers have gotten absurd. To keep paying its sewer system debt, Jefferson County would have to come up with $577 million this fiscal year. That's four times what the county's sewer system makes in a year. To get out of backfiring interest rate swaps, the county would have to shell out $735 million. That's more than the entire county budget.[250]

Jefferson County has placed itself in a very precarious situation, with few options remaining. At this point, the County appears to be faced with three possibilities: (1) refinancing the debt; (2) bankruptcy; or (3) receivership.[251]

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244. *Id.*

245. *Id.* at 59.

246. A "basis point" is equal to .01%, or 1/100th of a percent. TEMEL, *supra* note 112, at 240.

247. Braun, *supra* note 2, at 59.

248. *Id.*

249. *See* Mary Buckelew, Jeff Germany, Chris McNair & Gary White, *Negotiated vs. Bid with Negotiated Issue, County Getting Best Professional Services at Lowest Price*, BIRMINGHAM NEWS, July 30, 1996, at 5.

250. Thomas Spencer, *Jeffco's Three Painful Choices: Receivership, Bankruptcy or Deal Jeffco Has Three Choices in Sewer Crisis*, BIRMINGHAM NEWS, Dec. 21, 2008, at 1A.

251. *Id.*

1. Refinancing

a. County Proposals

The County has floated several plans to try to deal with its escalating debt situation. The latest to gain traction has four basic components.[252] The first component involved putting a cap on sewer rate increases of 2.85% and employing more efficient debt collection techniques.[253] The final maturity on this new debt would be 50 years, with the revenues from the sewer system dedicated to paying off the debt.[254] The second component required a buy-back of the County's auction-rate securities—some $2.2 billion worth—by JPMorgan and Bank of America.[255] Third, instead of replacing the County's variable rate bonds with fixed-rate securities that required the County to pay hefty fees, the banks would exchange the securities.[256] Finally, current holders of variable-rate and auction-rate bonds would then exchange these securities for fixed rate bonds at an interest rate of 3.8%.[257]

Robert Brooks, a finance professor at the University of Alabama, believes the County's position with the banks may have actually become stronger in recent months and that the banks may have made a mistake by not trying to come to an agreement with the County during the first half of 2008.[258] He asserts that continued turbulence in the markets, coupled with bankruptcies and bail-outs, has contributed to put the County in a better negotiating posture than it would have been in during the first half of the year.[259] Now, with conditions as they are, asking the County to increase taxes and rates on customers (and voters) who are already economically distressed would not be something that the County would want—or that the local and state legislators would allow.[260]

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252. *See* Barnett Wright, *New Plan Raises Rates, Not Taxes; Requires Banks, Insurers to Absorb Losses*, BIRMINGHAM NEWS, Sept. 3, 2008, at 1A (discussing Jefferson County's plan to resolve its sewer-debt crisis) [hereinafter Wright, *New Plan Raises Rates*].

253. *Id.*

254. Shelly Sigo, *Alabama Gov. Bob Riley Seeks TARP Eyes Backstop for Sewer Debt Plan*, BOND BUYER, Oct. 8, 2008, at 365 THE REGIONS 1 [hereinafter Sigo, *Alabama Gov. Seeks TARP*].

255. Wright, *New Plan Raises Rates*, supra note 252.

256. *Id.*

257. *Id.*

258. Spencer, *supra* note 250.

259. *Id.*

260. *Id.*

Bettye Fine Collins, the President of the Jefferson County commission, met with state legislators to discuss the possible creation of a management authority to oversee the sewer system.[261] In addition to the creation of an oversight board, other possibilities coming from these discussions included the creation of a state authority that would "oversee the issuance and repayment of bonds."[262] Also proposed was the possibility of allowing some of the County sales taxes to be reallocated for the purposes of reducing the County's sewer debt.[263] Legislators also requested that the County further try to reduce its debt through additional budget cuts.[264]

b. TARP

In early October 2008, Alabama Governor Bob Riley contacted the then-interim assistant Treasury secretary overseeing the Troubled Asset Relief Program ("TARP"), Neel Kashkari, and called Jefferson County "a poster child for how the subprime mortgage crisis is hurting Main Street America."[265] At that time, Jefferson County's creditors had "agreed to contribute $650 million . . . to support refinancing of the $3.2 billion sewer system debt."[266] However, the refinancing of the remaining debt would require that sewer rates be increased even more, placing a further burden on the already over-stressed users of the sewer system.[267] Governor Riley told Kashkari that the County had "no other revenue sources it [could] apply to the sewer debt," as Jefferson County sought "a backstop of the balance of the refinanced debt (approximately $2.7 billion) from the guaranty program created by TARP."[268]

According to the Governor, this was "a very efficient, cost-effective, and politically attractive way to promote the core purposes of TARP," and would "address the incredible costs that have been inflicted on the county by insurer downgrades and illiquidity in the municipal bond market as a result of the subprime mortgage crisis."[269]

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261. Barnett Wright, *Collins, Legislators in Talks on Sewer Oversight; Authority Considered*, BIRMINGHAM NEWS, Dec. 30, 2008, at 1A.

262. *Id.*

263. *Id.*

264. *Id.*

265. Sigo, *Alabama Gov. Seeks TARP*, *supra* note 254.

266. *Id.*

267. *Id.*

268. *Id.*

269. *Id.*

The Governor's request was denied.[270] However, with a new administration now in office, the Governor will try once again to obtain TARP money or money from another source to help Jefferson County come out of this crisis.[271]

2. Bankruptcy

In early 2008, when it became evident that Jefferson County was in serious financial trouble, the word "bankruptcy" began to be mentioned as the only possible outcome.[272] Although the County tried to dodge the issue for months,[273] it began to be a rallying cry for some members of the County commission when it was tied to a possible solution to the County's problems.[274]

In July 2008 David Bronner, head of Retirement Systems of Alabama ("RSA"), proposed a plan requiring the County to declare bankruptcy for the sewer system, thus putting the system under court supervision.[275] RSA would then buy the sewer system from the court.[276] Holders of sewer debt would receive approximately $1.2 billion less than the $3.2 billion owed and would therefore need to collect the remainder from the bond insurers.[277] "'We have all heard of Orange County, Calif. They did about the same thing that Jefferson County did to get into trouble,' Bronner said. 'Orange County filed Chapter 9. Was their credit impaired? No.'"[278] His proposal met with favor from some County commissioners, but was rejected by the majority and was never acted upon.[279] Mr. Bronner may still be interested in pursuing his plan with the County, having expressed his

270. Michael Tomberlin, *Riley Suggests Uncle Sam Cosign on Jeffco Sewer Debt*, BIRMINGHAM NEWS, Oct. 29, 2008, at 1D.

271. Barnett Wright & William Thornton, *Riley Says Transition Could Aid Debt; Crisis Suggests County Wait to See Obama's Plans*, BIRMINGHAM NEWS, Dec. 17, 2008, at 1A.

272. *See, e.g.*, *Moody's Downgrades Jefferson County's (Al) Sewer Revenue Rating to Caa3*, BOND BUYER, Mar. 27, 2008, *available at* http://www.bondbuyer.com/printthis.html?id=20080327QEBMUX3Y.

273. *See, e.g.*, Shelly Sigo, *Jeffersonian Dissent; County Contests S&P Downgrade to D*, THE BOND BUYER, Apr. 4, 2008, at 364 NEWS 1.

274. Russell Hubbard, *Bronner Proposes Plan to Buy Sewer Bankruptcy Sale Could Get Ratepayers Off Hook*, THE BIRMINGHAM NEWS, July 24, 2008, at 1A.

275. *Id.*

276. *Id.*

277. *Id.*

278. Shelly Sigo, *Chapter 9 Urged for Jefferson County*, BOND BUYER, Aug. 18, 2008, at 365 THE REGIONS 1.

279. Shelly Sigo, *Jefferson County Sets Public Meeting to Discuss Ongoing Sewer-Debt Crisis*, BOND BUYER, July 30, 2008, at THE REGIONS 28.

continuing interest to County Commissioner Jim Carns in early 2009.[280]

Commission President Bettye Fine Collins is still attempting to reach a settlement on Jefferson County's debt.[281] However, after over a year of trying to find ways out of the crisis, she now says that if a settlement is not reached by the middle of 2009, then the County will have to seriously consider filing for protection under Chapter 9 of the U.S. Bankruptcy Code.[282]

3. Receivership

> After many months of efforts by the Bond Insurers, other creditors and interested parties to work with Jefferson County to resolve this financial crisis, we are disappointed to have to take this action . . . . However, the County Commission's failure to meet its obligations has left us with no other alternative. We are hopeful that the appointment of an independent party will provide a solution that fairly accommodates the needs of the County, its citizens and its creditors.[283]

As previously stated, Syncora and FGIC, with The Bank of New York Mellon as Trustee, filed suit requesting the court to appoint an independent receiver for the purposes of: (1) managing the County's sewer system; (2) implementing modifications to the County's sewer rates and exploring other potential sources of revenue; (3) making sure any actions are in compliance with all applicable laws; and (4) assisting in an appropriate financial resolution to the matter as well as pursuing any valid claims.[284]

This action was taken after the County experienced a further ratings downgrade when it "used debt service reserves to make payments on its sewer debt."[285]

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280. Lauren B. Cooper, *Carns: Bronner Offer to Buy Sewer Still on Table*, BIRMINGHAM BUS. J. (2009), *available at* 2009 WLNR 388556.

281. Barnett Wright, *Collins Sees June Sewer Debt Crisis Deadline Commissioner Says Bankruptcy Likely if Solution Remains Elusive*, BIRMINGHAM NEWS, Dec. 28, 2008, at 1A.

282. *Id.*

283. Insurer Press Release, *supra* note 43 (comments of Edward Hubbard, President of Syncora).

284. *Id.*

285. Shelly Sigo, *Jefferson Co. Back in* Court: *Insurers, Trustee Seek Receivership*, THE BOND BUYER, Sept. 18, 2008, at 365 SOUTHEAST 1.

In November 2008 special masters were appointed by the court to investigate the operation of the County's sewer system and make recommendations concerning the disputes between the parties.[286] This investigation was to focus on ways in which the County could bring in more revenue for the system, possible rate increases, ways in which the system could cut expenses, and any claims against other parties.[287]

The report was issued January 19, 2009 and advised the County to continue to solicit help from the state and federal governments to alleviate its debt burden.[288] In addition, the report recommended the County examine whether it could charge a fee to County residents not currently on the sewer system in an effort to increase revenues.[289] The report also recommended staffing changes in the sewer department and establishing a method to make sure that all County residents and businesses who were receiving sewer services were paying for such service.[290]

The full hearing on this case, originally scheduled for February 25, 2009, will be rescheduled for a later date.[291]

IV. CONCLUSION

Jefferson County, Alabama is experiencing what some have called the "'perfect storm' of fiscal distress,"[292] where good, old-fashioned government corruption and incompetence have run head first into the worst financial crisis to occur in the United States since the Great Depression. After more than a year of turmoil, the County still does not know how the storm will end—in bankruptcy, receivership, or the working-out of a deal with creditors to pay back its massive debt.

However, there is still a glimmer of hope for Jefferson County. Perhaps help will come in the form of aid from one of the Obama administration's bail-out programs. Perhaps state and local officials will finally come together to reach an agreement so that negotiations with creditors can proceed. If not, bankruptcy or receivership await in the balance. We will

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286. Sigo, *Special Master Ordered, supra* note 44.

287. *Id.*

288. *Id.*

289. *Id.*

290. Barnett Wright, *Special Master Suggests Nonuser Fee, Federal and State Assistance*, BIRMINGHAM NEWS, Jan. 20, 2009, at 1A.

291. *See* Shelly Sigo, *Judge in Jefferson County Case Puts Off Holding a Full Hearing*, BOND BUYER, Feb. 24, 2009, at 367 THE REGIONS 3.

292. Petersen, *supra* note 138.

know shortly whether Jefferson County will be redeemed through programs and negotiations—or whether it will be admitted into that exclusive club with Orange County and its predecessors.

Robin Smith