

Chapman Client Alert

January 11, 2018

Current Issues Relevant to Our Clients

Bankruptcy Eligibility Ruling: *In re Lombard Public Facilities Corporation*

As state and local governments seek more creative financing methods for economic development projects, some have turned to the formation of subsidiary entities that can provide financing assistance, potentially without triggering debt limits under state or local laws or violating covenants under existing financings. These subsidiaries may also help shield local governments if the relevant economic development project becomes distressed, as happened recently with a convention center in the Village of Lombard, Illinois (the “*Village*”). When these projects become distressed, however, the question becomes whether the financing subsidiary is permitted to file a petition under Chapter 11 of the U.S. Bankruptcy Code (the “*Bankruptcy Code*”) or whether the subsidiary’s only recourse would be to file a petition under Chapter 9 of the Bankruptcy Code (the municipal bankruptcy provisions), assuming it could meet Chapter 9’s stringent eligibility requirements.

A recent bankruptcy case in the U.S. Bankruptcy Court for the Northern District of Illinois has found that, although a very fact specific endeavor, such subsidiary entities may indeed be eligible for relief as “persons” under Chapter 11 of the Bankruptcy Code. In the case, *In re Lombard Public Facilities Corporation*, the Bankruptcy Court examined whether the Lombard Public Facilities Corporation, a public facilities corporation formed by the Village of Lombard, Illinois (the “*Village*”) which had filed a Chapter 11 petition with such Court, was a “governmental unit” under the Bankruptcy Code, and thus only eligible to file a petition under Chapter 9.¹ The Bankruptcy Court found that, although the Village had formed the Debtor, because the Village was not “actively engaged” in operating the Debtor’s business, the Debtor was not a “governmental unit” as defined in the Bankruptcy Code, and thus was permitted to file a Chapter 11 petition.

Background

The Debtor was incorporated in 2003 by the Village as a not-for-profit corporation, to act on behalf of the Village in financing and constructing a hotel and convention center within the Village (the “*Project*”). As described in Judge Cox’s decision, because the Village would have exceeded its state law debt limit if it were to finance the Project on its own, it formed the Debtor as a separate entity to permit the full financing of the convention center. And, in fact, the State of Illinois had created a mechanism under its laws permitting certain municipalities to establish public facilities corporations to help acquire rights and property for municipal convention halls.²

The Village’s ordinance forming the Debtor (the “*Authorizing Ordinance*”) provided that the Debtor could issue bonds, construct the Project, and encumber the Project as security for the bonds. The Village could in turn later accept from the Debtor title to the Project free and clear of any encumbrances upon the redemption and retirement of all issued bonds. The

Village’s taxing power, and full faith and credit, however, were not pledged for security of the bonds.

Following the requirements of the Authorizing Ordinance, the Debtor financed the acquisition and build-out of the Project by issuing a series of tax-exempt bonds (the “*Bonds*”) in or around 2005. Revenue shortfalls in the Project caused the Debtor to become distressed, however, and the Debtor filed a petition under Chapter 11 of the Bankruptcy Code on July 28, 2017.

A creditor and the United States Trustee separately petitioned the Bankruptcy Court to dismiss the Debtor’s bankruptcy case on the basis that the Debtor was a “governmental unit” ineligible to file for bankruptcy relief under Chapter 11 of the Bankruptcy Code.

The Decision

An entity is eligible for bankruptcy relief under Chapter 11 of the Bankruptcy Code, with certain exceptions, if it is a “person.” The Bankruptcy Code’s definition of a “person,”

however, in relevant part, specifically excludes “government units,” which term is defined by the Bankruptcy Code as, “United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States . . . , a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government.” 11 U.S.C. § 101(27). A so-identified “governmental unit” can only file for bankruptcy under Chapter 9 of the Bankruptcy Code, and only then if such entity meets the stringent eligibility requirements of Chapter 9.

Although the legislative history of the Bankruptcy Code suggests that bankruptcy courts should interpret the definition of “governmental unit” broadly, the Bankruptcy Court determined that the definition should not be interpreted so *broadly* as to encompass an entity not actually carrying out some governmental function.

In line with the decision of *In re Las Vegas Monorail Co.*, 429 B.R. 770,788 (Bankr. D. Nev. 2010), the Bankruptcy Court’s focus was on three key questions -- (1) whether the entity in question has traditional governmental attributes, or engages in traditional governmental functions; (2) the extent of state control over the entities attributes and functions; and finally (3) the state categorization of the entity in question.

Ultimately, the Bankruptcy Court found that (1) the Debtor was not engaging in traditional government functions; (2) there was no meaningful Village control over the Debtor; and (3) that the Village’s categorization of the Debtor as a “governmental unit” was not dispositive. Thus, the Bankruptcy Court determined that the Debtor was not a “governmental entity,” and was an eligible debtor under Chapter 11 of the Bankruptcy Code. In making its determination, the Bankruptcy Court examined several factors:

No Full Faith and Credit Pledge. The Village’s taxing power and full faith and credit were not pledged as security for any bonds issued by the Debtor.

Project Not Actively Carrying Out Essential Governmental Function. Because the Debtor was operating as an independent commercial entity competing with other convention facilities, the Bankruptcy Court concluded that it was not actually carrying out any identifiable governmental function of the Village. The Bankruptcy Court further noted that while generating and encouraging economic activity is worthwhile, it is not a core government function.

No Agency. Under the Authorizing Ordinance, the Village was permitted, but not required, to accept from the Debtor the Project in the future. The Village, for instance, could reject an offer to transfer the Project if it were encumbered by liens. This lack of liability and responsibility with respect to the Project, indicated that the Debtor was not acting as the Village’s agent, which supported a finding that the Debtor was not a “governmental unit” for bankruptcy eligibility purposes.

Being “Subject to” State Law Is Insufficient. The fact that the Debtor was “subject to” certain governmental ethics and “sunshine” laws in its enacting ordinance is, alone, insufficient to establish governmental control. In this regard, the Bankruptcy Court also questioned whether the Debtor would be protected by the state’s local government tort immunity provisions, which it found to be a further reason to find that the Debtor was eligible to file a Chapter 11 petition.

A Board Comprised of Municipal Employees May Be Insufficient. While the Debtor was controlled by a board of directors comprised of Village employees who were appointed by the Village, the fact that the Project had an independent asset manager, and separate hotel and restaurant managers who reported to the asset manager, not to the Village, weighed against a finding that the Debtor was a “governmental unit.”

Inclusion in Municipal Financial Statements Is Insufficient. Although the Village included the Debtor in its financial statements, and the Village and the Debtor were party to agreements of financial support, none were binding on the Village.

Past State Court Rulings Have Persuasive Value. Prior to its bankruptcy filing, the Debtor failed to have itself declared to be a “governmental unit” (and therefore gain certain benefits) before the Illinois Department of Revenue and in proceedings before an Illinois state court. The Illinois Appellate Court found that the Debtor did not have authority to impose taxes, maintain a police force, provide water or sewage treatment and had not received a charter from the State of Illinois recognizing it as a governmental body. These earlier state court rulings informed the Bankruptcy Court’s holding, and the Debtor’s statements in support of its being declared a “governmental unit” before the Department of Revenue and the Circuit Court were not treated as conclusive.

Appeal

On December 20, 2017, a creditor appealed the Bankruptcy Court's decision, which appeal is pending before Judge Edmond E. Chang of the Northern District of Illinois.³

Conclusion

Only a small number of cases have addressed the eligibility of quasi-governmental entities for bankruptcy protection under Chapter 11 of the Bankruptcy Code. This addition to the case law canon confirms that such eligibility analyses are intensely fact specific inquiries. Thus, practitioners should seek advice regarding bankruptcy eligibility before any transaction closes to properly assess any bankruptcy risk.

For More Information

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- 1 Case No. (17-B-22517) (Bankr. N.D. Ill.).
 - 2 See 65 Ill. Comp. Stat. 5/11-65-10(a).
 - 3 Case No. (17-cv-09211) (N.D. Ill.).

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