

Chapman Client Alert

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Current Issues Relevant to Our Clients

Sixth Circuit Weighs in on the Meaning of “Governmental Unit”

A recent appellate court decision has provided additional guidance regarding the meaning of “governmental unit” under the U.S. Bankruptcy Code (the “*Bankruptcy Code*”).¹ This determination is important because if it is a “governmental unit,” an entity would only be eligible to file a bankruptcy petition if it is a “municipality” under the Bankruptcy Code and meets the other eligibility requirements for filing a municipal bankruptcy petition.

In the decision by the U.S. Court of Appeals for the Sixth Circuit (the “*Sixth Circuit*”), the Sixth Circuit provided additional guidance for creditors of municipal and quasi-municipal entities as to what constitutes a “governmental unit.” Pursuant to the Sixth Circuit’s decision, along with a developing line of case law leading up to the decision, it may be possible to structure a transaction with an entity that is a “governmental unit” but does not meet the eligibility requirements to file a Chapter 9 petition. If a court were to find that an entity is a “governmental unit” but not a “municipality” (each as defined in the Bankruptcy Code), then the entity would be ineligible for bankruptcy relief and, thus, would be bankruptcy remote.

Background

As we have previously explained,² an entity is generally eligible for bankruptcy relief under Chapters 7 and 11 of the Bankruptcy Code if it is considered a “person.”³ With limited exceptions, the definition of “person” under the Bankruptcy Code excludes any “governmental unit,” which is defined as the “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.”⁴

Importantly, a governmental unit may only file a petition under the Bankruptcy Code, if at all, under Chapter 9, but it must meet strict eligibility requirements for filing a municipal bankruptcy petition.⁵ One of these requirements is that the governmental unit is a “municipality” under the Bankruptcy Code, which is defined as a “political subdivision or public agency or instrumentality of a State.”⁶

Therefore, if an entity meets the definition of “governmental unit” but does not meet the stricter definition of “municipality,” it would be unable to file for bankruptcy relief. For example, one U.S. district court has found that a public employees retirement fund was a “governmental unit” under the Bankruptcy Code but not a “municipality.” Because the retirement fund in question was a “governmental unit” but not a “municipality,” it could not seek relief under the Bankruptcy Code.⁷

In previous court decisions, including *In re Las Vegas Monorail Co.*, 429 B.R. 770, 788 (Bankr. D.Nev. 2010), and *In re*

Lombard Public Facilities Corporation, 579 B.R. 493 (Bankr. N.D. Ill. 2017), courts have examined three key questions to determine whether an entity is a “governmental unit” for the purposes of the Bankruptcy Code. These questions include (1) whether the entity in question has traditional governmental attributes or engages in traditional governmental functions; (2) the extent of state control over the entity’s attributes and functions; and (3) the state categorization of the entity in question.⁸ Although the Sixth Circuit found these factors persuasive, as will be discussed, it chose not to adopt this test, and rather favored a holistic analysis of the entity in question, with a strong emphasis upon determining the degree of control exercised by the state or its agent over the entity.

Sixth Circuit Decision

In *Kentucky Employees Retirement System v. Seven Counties Services, Inc.*, the Sixth Circuit examined whether a nonprofit entity, the Seven Counties Services, Inc. (“*Seven Counties*”), that provided mental health services as a licensed “community mental health center” in Kentucky was a governmental unit and, thus, ineligible to file a petition under Chapter 11 of the Bankruptcy Code.⁹ In an unusual situation, although *Seven Counties* was formed as a nonprofit entity under Kentucky law, it participated in the Kentucky Employees Retirement System (“*KERS*”), a retirement system generally reserved for government employees. *Seven Counties* wanted to terminate its contract with *KERS*, which required *Seven Counties* to contribute 24% of its wages to *KERS*, but no mechanism existed under state law for its withdrawal. Because of this, *Seven Counties* filed its Chapter 11 bankruptcy petition in an effort to reject the burdensome obligation.

KERS, in an attempt to prevent Seven Counties' withdrawal from the system, which it estimated would leave KERS with a shortfall of \$90 million, asserted that Seven Counties was a "governmental unit" as an instrumentality of the Commonwealth of Kentucky, and thus ineligible for Chapter 11 relief. The Sixth Circuit's decision focused on this determination. In its review, the Sixth Circuit noted that "[g]overnmental control ... plays a critical role in identifying state instrumentalities."¹⁰

Although the Sixth Circuit did not adopt the test identified above from the *Las Vegas Monorail* case, it found the *Las Vegas Monorail* reasoning persuasive. In fact, the Sixth Circuit appeared to focus on three main issues in determining whether Seven Counties was a "governmental unit," including (1) the extent of government control, (2) whether the entity possessed any governmental attributes, such as eminent domain power or the power to tax, and, finally, (3) the state's classification of the entity.¹¹

In applying what appears to be a totality of the circumstances test in determining government control of the entity, the Sixth Circuit examined (1) whether the government created the entity; (2) whether the government appoints the entity's leadership; (3) whether an enabling statute guides or otherwise circumscribes the entity's actions; (4) whether and how the entity receives government funding; and (5) whether the government can destroy the entity.

In its decision, however, the Sixth Circuit noted that an analysis may not be limited to these factors, but that "[w]hile governmental control of an entity's day-to-day operations would certainly be sufficient to deem it a governmental instrumentality ... the granular level of control is not necessary here."¹² Based on these control-related factors, the Sixth Circuit found that Seven Counties was not a state instrumentality because it was not created or run by the Commonwealth of Kentucky either directly or through an enabling statute, does not receive funding through a mechanism commonly reserved for public entities, and could not unilaterally be destroyed by the Commonwealth of Kentucky.¹³

As noted above, the Sixth Circuit also found that, although critical, governmental control was not the only factor to consider in distinguishing a private entity from a governmental instrumentality. The Sixth Circuit examined whether Seven Counties possessed any governmental attributes, such as the

power of eminent domain or the power to levy taxes, to find that Seven Counties did not have such attributes.¹⁴ Finally, in concluding that Seven Counties was not a "governmental unit," the Sixth Circuit noted that it "would hesitate to second-guess a state's classification of its own governmental entities."¹⁵

Accordingly, following the trend of the lower courts in Nevada and Illinois, the Sixth Circuit applied a holistic analysis to determine whether Seven Counties was an instrumentality of the Commonwealth of Kentucky and thus a "governmental unit" under the Bankruptcy Code. Finding that Seven Counties was not an instrumentality of Kentucky, the Sixth Circuit upheld the lower court's decision finding Seven Counties eligible to file its Chapter 11 petition.¹⁶

Conclusion

Although the Sixth Circuit chose not to specifically adopt the *Las Vegas Monorail* test that some courts, such as the Northern District of Illinois bankruptcy court, have followed in analyzing whether an entity is a "governmental unit" for the purposes of the Bankruptcy Code, the Sixth Circuit's analysis followed a similar analysis in determining Chapter 11 eligibility, although the court considered the state's control of the entity the most important factor. Courts analyzing these situations, however, likely will look to the totality of the circumstances to determine whether or not a particular entity is a "governmental unit."

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1 *Kentucky Emps. Ret. Sys. v. Seven Counties Servs., Inc.*, 901 F.3d 718 (6th Cir. 2018). The appellant has filed a motion for the Sixth Circuit to rehear the case *en banc*.

2 See [The Bankruptcy Eligibility of Quasi-Government Entities](#).

- 3 11 U.S.C. § 101(41) (“The term ‘person’ includes individual, partnership, and corporation, but does not include governmental unit ...”).
- 4 11 U.S.C. § 101(27).
- 5 11 U.S.C. § 109(c).
- 6 11 U.S.C. § 101(40).
- 7 *In re Northern Mariana Islands Ret. Fund*, 2012 WL 8654317, at *3 (D. N. Mar. I. June 13, 2012). The court noted as follows: “Most people would agree that a state police force is an ‘instrumentality’ of the state government and therefore is a ‘governmental unit.’ Most people would also agree that a state police force is not a ‘municipality’ under any reasonable definition of that word, even though it is an ‘instrumentality’ of the state. In other words, since every ‘instrumentality of ... a State’ is a ‘governmental unit,’ but not every ‘instrumentality of a State’ is a ‘municipality,’ the word ‘instrumentality’ must have a different meaning in the two contexts.” *Id.*
- 8 *Lombard*, 579 B.R. at 503–04 (citing *Las Vegas Monorail*, 429 B.R. at 788–90).
- 9 *Kentucky Emps. Ret. Sys. v. Seven Counties Servs., Inc.*, 901 F.3d 718 (6th Cir. 2018).
- 10 *Id.* at 726. Note that in a lengthy dissent, Judge McKeague questioned the reasoning of the majority’s decision.
- 11 *Id.* at 727.
- 12 *Id.*
- 13 *Id.* at 729.
- 14 *Id.* at 730.
- 15 *Id.*; *cf. In re Kenneth Allen Knight Tr.*, 303 F.3d 671, 678 (6th Cir. 2002) (holding that access to the federal bankruptcy courts and bankruptcy relief is a matter of federal, not state, law) (citation omitted).
- 16 Note that although the Sixth Circuit found Seven Counties to be eligible to file a Chapter 11 petition, it certified a question to the Kentucky Supreme Court to determine whether or not Seven Counties could utilize the Bankruptcy Code to reject its obligation to KERS.

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