



Insights

The Bankruptcy Eligibility of Quasi-Government Entities

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In order to properly commence a bankruptcy case, the debtor bears the burden of establishing that it meets the applicable bankruptcy eligibility requirements. Generally, any “person” is permitted to pursue relief under Chapter 11 of the U.S. Bankruptcy Code. However, the definition of “person” specifically excludes any “governmental unit” for purposes of bankruptcy eligibility. In bankruptcy cases where a not-for-profit corporation is closely related to or controlled by a governmental unit, a creditor may challenge the not-for-profit corporation’s eligibility, arguing that the not-for-profit corporation is, in substance, a “governmental unit” and therefore not eligible to file a Chapter 11 petition.

A recent bankruptcy eligibility ruling by Judge Jacqueline P. Cox of the U.S. Bankruptcy Court for the Northern District of Illinois examined this issue. In that case, *In re Lombard Public Facilities Corp.*,¹ the bankruptcy court found, in a fact-specific analysis, that an Illinois public facilities corporation is eligible to restructure its debts under Chapter 11 of the Bankruptcy Code. The bankruptcy court applied established law to determine that the Lombard Public Facilities Corp., a public facilities corporation (the “debtor”), formed by the Village of Lombard, Illinois, was properly eligible to file under Chapter 11.

The bankruptcy court found that because (1) the village was not “actively engaged” in operating the debtor’s business, and (2) the debtor’s chief business — operation of a convention center — was not an essential governmental function, the debtor was not a “governmental unit” as defined in the Bankruptcy Code, and thus was eligible to file a Chapter 11 petition notwithstanding the fact that the village had formed the debtor.

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While this case does not break any new ground, or depart from commonly accepted principles of bankruptcy eligibility, it serves as a reminder that eligibility is a fact-specific inquiry, and that bankruptcy eligibility should be considered at the outset of any relationship with a not-for-profit entity. For example, creditors dealing with not-for-profit corporations with a perceived bankruptcy risk can potentially explore documentation tools to minimize bankruptcy risks with counsel. At a minimum, a proper preclosing bankruptcy risk assessment can avoid future surprises and facilitate the negotiation of proper pricing and other terms of the transaction.

Background

An entity is generally eligible for bankruptcy relief under Chapter 11 of the Bankruptcy Code if it is a “person.” However, the Bankruptcy Code’s definition of a “person” excludes “governmental units,” with certain limited exceptions. A “governmental unit” is defined 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 “governmental unit” can only file for bankruptcy under the municipal bankruptcy provisions of Chapter 9, and must also meet strict eligibility requirements that are not applicable in cases under Chapters 7 or 11.²

Bankruptcy cases involving not-for-profit corporations ordinarily must be filed under Chapter 7, which typically results in a liquidation of the debtor, or Chapter 11, which typically results in a reorganization of the debtor. Thus, if the not-for-profit corporation is deemed a “governmental unit,” the Chapter 7 or Chapter 11 case must be dismissed.³

In this case, 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 (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 facilitate the financing of the convention center. 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.⁴

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 title to the project free and clear of any encumbrances upon the redemption and retirement of all issued bonds. Neither the village’s taxing power nor its full faith and credit were pledged as security for 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 in or around 2005. However, revenue shortfalls in the project caused the debtor to become distressed, 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. Various other parties-in-interest joined in the arguments for and against dismissal.

The Decision

The bankruptcy court's decision hinged on the interpretation and application of the definition of "governmental unit." 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.⁵

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) the village's own categorization of the debtor as a "governmental unit" was not dispositive. Thus, the bankruptcy court determined that the debtor was not a "governmental unit," 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.⁶

No Agency

Under the authorizing ordinance, the village was permitted, but not required, to accept title to the project from the debtor 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 Dec. 20, 2017, the creditor that initially challenged the debtor’s bankruptcy filing filed a petition for leave to appeal the bankruptcy court’s decision to the district court, which was assigned to Judge Edmond E. Chang of the Northern District of Illinois.⁷ Since the bankruptcy court’s ruling denying the motion to dismiss was an “interlocutory order,” i.e., an order that does not finally resolve all of the issues in the case, leave of the district court was required to pursue an immediate appeal.

In its petition for leave to appeal, the creditor generally asserted that the bankruptcy court’s interpretation of the term “instrumentality” was unduly restrictive, in part because the Bankruptcy Code defines the term “governmental unit” to include not only a municipality, but also an “instrumentality” of a municipality. Subsequent to the filing of the petition for leave to appeal, the creditor sold the bonds that formed the basis for its claims in the bankruptcy case. As a result, the petition for leave to appeal became moot, and was

dismissed by the district court on Jan. 31, 2018. Thus, absent a new challenge, the debtor is likely to proceed through the bankruptcy process and adjust its debts in accordance with the provisions of Chapter 11.

Conclusion

Only a small number of cases have addressed the eligibility of quasi-governmental entities for bankruptcy protection. This addition to the case law canon confirms that each eligibility analysis is an intensely fact-specific inquiry. Thus, practitioners should consider seeking advice regarding bankruptcy eligibility before a transaction closes in order to properly assess and potentially mitigate any bankruptcy risk.

1. Case No. (17-B-22517) (Bankr. N.D. Ill.).
2. The Bankruptcy Code also bars not-for-profit corporations from being placed into bankruptcy involuntarily under either Chapter 7 or 11. 11 U.S.C. 303(a). Similarly, a Chapter 9-eligible entity cannot be placed into involuntary bankruptcy. *Id.*; see also 11 U.S.C. 901(a) (303, which governs involuntary bankruptcy, is not incorporated into Chapter 9).
3. Note that the not-for-profit corporation could potentially ask the court to convert the case to one under Chapter 9 if it meets the strict eligibility requirements.
4. See 65 Ill. Comp. Stat. 5/11-65-10(a).
5. The bankruptcy court also discussed the familiar cases of *In re Northern Mariana Islands Retirement Fund*, 2012 WL 8654317 (D.N. Mar. I. 2012) and *TI Federal Credit Unit v. DelBonis*, 72 F.3d 921, 937-38 (1st Cir. 1995), distinguishing them on the grounds that the convention center in question is a commercial enterprise, rather than a governmental function of the village. It similarly distinguished *U.S. Trustee v. Hospital Authority of Charlton County (In re Hospital Authority of Charlton County)*, 2012 WL 2905796 (Bankr. S.D. Ga. 2012) on the grounds that, unlike the convention center in question, the hospital authority was a “governmental unit” because it was: (1) created by statute, (2) was exempt from paying taxes and received tax revenues from the county’s general fund or ad valorem taxes, and (3) issued tax-exempt revenue anticipation certificates.
6. While the operation of a hotel and convention center may not be, strictly speaking, an essential governmental function, the Illinois General Assembly has suggested in other contexts that encouraging economic opportunity is an important governmental responsibility. See, e.g., 20 ILCS 3501/801-5(f) (finding “that the State has a responsibility to help create a favorable climate for new and improved job opportunities for its citizens by encouraging the development of commercial businesses and industrial and manufacturing plants within the State.”)
7. Case No. (17-cv-09211) (N.D. Ill.).

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