Chapter 11 or Chapter 9: Investors Beware.

Municipalities often drive economic development through subsidiaries and affiliated entities. When these "quasi-municipalities" become distressed, however, questions arise as to whether the potential debtor qualifies as a debtor under Chapter 11 or Chapter 9. This uncertainty can lead to litigation over whether the entity may proceed as a Chapter 11 debtor or is a governmental unit that must proceed through a Chapter 9 bankruptcy filing. In states where Chapter 9 is not authorized, Chapter 11 may be the only available option for a supervised restructuring. Answering the question of "what kind of debtor" is the issuer is an important part of the due diligence process because the answer impacts whether the entity can file at all if it is a governmental entity or whether the entity can proceed in Chapter 11.

In this blog we look at two cases, one in Illinois and one in Nevada, where the primary issue was whether the debtor could proceed as a Chapter 11 debtor or was precluded from a Chapter 11 proceeding because it was a governmental unit ineligible for Chapter 11. Chapter 9 was not an option in either case because Nevada and Illinois do not authorize governmental units to seek relief under Chapter 9.

Lombard Public Facilities Corporation

The most recent case is from the United States Bankruptcy Court for the Northern District of Illinois. In *In re Lombard Public Facilities Corporation*, Lord Abbett Municipal Income Fund, Inc. – Lord Abbett High Yield Municipal Bond Fund ("Lord Abbett") and the United States Trustee (the "U.S. Trustee") separately sought to dismiss the Chapter 11 case of the Lombard Public Facilities Corporation (the "LPFC"). In support of their motions, Lord Abbett and the U.S. Trustee contended that the LPFC was not an eligible debtor under Chapter 11 of the Bankruptcy Code because it was a governmental unit.

The arguments of Lord Abbett and the U.S. Trustee centered on Bankruptcy Code section 109(d) and whether the LPFC was a "person" eligible for Chapter 11. Pursuant to Bankruptcy Code section 101(41), "[t]he term 'person' includes individual, partnership, and corporation, but does not include governmental unit." The term governmental unit includes, among other things, municipalities and the instrumentalities of municipalities. Thus, the ultimate question considered by the court was if the LPFC was an instrumentality of the municipality that incorporated it.

The LPFC was formed by the Village of Lombard, Illinois (the "Village"), for the sole purpose of acting on behalf of the Village to finance, secure a location, and construct a convention hall and hotel facility. The LPFC was incorporated by the Village as a separate public facilities corporation because it was not otherwise authorized to borrow the funds needed for the project. Under Illinois law, public facilities corporations are the business agent of the municipality, and are controlled through the municipality's ability to appoint and remove directors and by having title to the project transferred to it upon the retirement of any bonds or other debt issued in connection with the development. The ordinance authorizing the creation of the LPFC provided for each of these activities.

The hotel and convention facility project was financed with a series of tax-exempt bond issuances. The LPFC was able to issue the bonds as tax-exempt because, as stated in the offering documents, it "constitutes an instrumentality of the Village for federal tax purposes." The LPFC took the same position in a 2003 application for exemption from the Illinois Retailers Occupation Tax Act. After the Illinois Department of Revenue denied the application, it stated in a complaint seeking to overturn the decision that (i) it was incorporated for the sole purpose of constructing the project, (ii) net income from the project would go to the Village, (iii) title to the property would vest in the Village for no consideration upon redemption or retirement of the bonds, (iv) it was the Village's alter ego, (v) it was formed to perform essential government functions, and (vi) everything it did was in furtherance of the Village's benefit.

Despite the structure of the LPFC and its statements in the earlier tax litigation, the court ultimately held that the LPFC was not a governmental unit as that term is defined in the Bankruptcy Code and, therefore, that it was eligible to be a debtor in Chapter 11. In reaching this conclusion, the court reviewed a number of precedents cited by the parties but paid special attention the analytical framework used to confront a similar question in the Las Vegas Monorail case.

Las Vegas Monorail

In *In re Las Vegas Monorail*, the Las Vegas Monorail Company (the "Monorail Company") was a nonprofit corporation formed to operate a monorail that connected certain hotels and a convention center in Las Vegas. As part of a planned expansion and the financing necessary to fund it, the Director (the "Director") of the Nevada Department of Business and Industry (the "Department") sponsored the issuance of approximately $650 million in municipal bonds. In connection with obtaining tax free status for the bonds, the Monorail Company signed a document that expressly stated it was an "instrumentality of the State of Nevada and controlled by the Governor of the State of Nevada." The Governor also exercised some level of control over the management and budgeting of the Monorail Company.

The proceeds of the bonds were lent to the Monorail Company pursuant to a financing agreement with the financing agreement as the only source of repayment (other than insurance) on the bonds. After the Monorail Company failed to make the required payments and sought protection under Chapter 11, Ambac Assurance Corp., which had insured the payment of principal and interest on the bonds, moved to dismiss the bankruptcy case asserting the Monorail Company was a governmental unit and ineligible for Chapter 11.

The *Las Vegas Monorail* court surveyed applicable case law and carefully considered whether the function performed by the Monorail Company was a core governmental function, whether the entity is sufficiently controlled by the government, and how the government classifies the entity. The court concluded that the Monorail Company was not a municipality or governmental instrumentality, and therefore eligible for Chapter 11, because (i) its monorail transportation goals did not constitute traditional government functions (i.e., it had no power to tax, exercise eminent domain, or claim sovereign immunity); (ii) the control available to the state governor over budgeting and, to some extent, its management, did not rise to the level of control necessary to be a municipality because the state bore no risk of loss; and (iii) Nevada state law did not treat the debtor as a municipality or instrumentality.

LFPC Found Not to be a Governmental Unit

As set forth above, the *Las Vegas Monorail* test suggests that a court consider (i) whether the entity in question has any traditional governmental attributes or engages in traditional government functions; (ii) the extent to which the entity in question is controlled by the government; and (iii) the

government's categorization of the entity. Applying that test to the LPFC, the court in Lombard found that the LPFC did not carry out a governmental function of the Village and noted that the LPFC was a commercial operation that competed with other hotel and convention centers. In other words, the court found that operating a hotel and convention center was not a core government function.

The court also found that, while the Village appointed the LPFC's directors and certain of its representatives engaged with the LPFC on minor matters, those actions alone did not rise to the level of control necessary to deem the LPFC a governmental unit. The LPFC was found to be responsible for its day to day management and operations and had an asset manager as well as separate hotel and restaurant managers that reported to the asset manager, not the Village. Finally, the court noted that the Illinois Department of Revenue previously concluded that the LPFC was not a tax-exempt instrumentality of the Village and agreed with that conclusion.

Importance of Investor Due Diligence

While the *Lombard* holding itself is not particularly earth shattering or surprising given the nature of the LPFC's business and the lack of a Chapter 9 option in Illinois, it does raise a number of important points for investors to consider when reviewing potential investments in quasi-municipal debt. Important takeaways include the following:

- The outcome of the investor's assessment of the issuing entity's status is critically important because it determines if the debt issuing entity is eligible for Chapter 11 or required to proceed in Chapter 9 (if available). In those states where the state has not authorized Chapter 9 bankruptcy filings, there is an increased likelihood that a bankruptcy court will work hard to find a way to allow a debtor to proceed in Chapter 11 given that there is no other bankruptcy option.
- Chapter 11 is often viewed as more desirable than a Chapter 9 proceeding because Chapter 11 proceedings are somewhat more predictable due to wide ranging precedent, greater certainty and greater creditor control. Chapter 9 has stringent eligibility requirements and leaves most, if not all, of the decision making power in the hands of the debtor. It also prevents the court from taking certain actions that are available to it in Chapter 11 (See 11 U.S.C. §904).
- Chapter 9 precedent is still in its infancy. Recent decisions out of Puerto Rico interpreting certain provisions of Chapter 9 that were long thought to compel post-petition payment of special revenue secured bonds, as well as rulings on the limits of the court's powers, exacerbate this concern.
- Statements in the offering documents that an entity is a governmental unit or instrumentality are not necessarily controlling and need to be reviewed carefully by both issuers and investors. If there is uncertainty as whether the issuer is a governmental unit or not, that uncertainty should be disclosed. There is a significant difference between operating as a Chapter 11 debtor and operating as a Chapter 9 debtor. Recent cases suggest that bondholders should not expect to recover as much in a Chapter 9 proceeding as they would expect to recover in a Chapter 11 proceeding given a municipality's obligation to provide a certain level of service and the challenges regarding restructuring of pension obligations.
- Making an independent assessment of an entity's legal status should be a priority item on all pre-investment diligence lists and for issuers in terms of making disclosures in the offering documents. This is not always an easy determination as many municipalities have subdivisions that issue debt and operate as independent subdivisions of a governmental unit in terms of governance and financing.

Litigation of the issues surrounding whether the issuer is a governmental unit or not can add uncertainty, delay and additional cost to the restructuring process. Both issuers and investors need to consider whether and what kind of bankruptcy process may be implemented in the event a restructuring is required.

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