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The 'Quasi-Instrumentality' Question: Chapter 9, Chapter 11, or Neither? - Arnold & Porter

The pandemic has led to both private and public entities struggling to service their debt. For entities straddling the line between private and public, it is not always clear whether they can restructure debts under Chapter 9, Chapter 11, or neither, say Arnold & Porter attorneys. They look at two court decisions for guidance for these quasi-instrumentalities.

As distribution of the Covid-19 vaccine provides optimism for a return to our pre-pandemic lives, there's little doubt of the pandemic's impact on individuals, businesses, as well as state and local governments. Also impacted are quasi-governmental entities—those created by local governments to serve some public purpose, such as a convention center, hotel, stadium, or parking garage.

Due to travel and gathering restrictions, revenues supporting these quasi-governmental entities have declined, leading to unscheduled draws on reserve accounts to meet debt service obligations—a potential canary in the coal mine?

If these entities are municipalities, they may have no option of reorganizing under the Bankruptcy Code in states that have not authorized municipalities to be Chapter 9 debtors. In such states, the only option is Chapter 11, provided the entity is a "person" under the Bankruptcy Code.

Relatively few cases have analyzed whether an entity formed by a local government is a "person" eligible for Chapter 11 relief or a "municipality" (which includes instrumentalities of a state) eligible for Chapter 9. The courts' analyses in *In re Las Vegas Monorail Co.* and *In re Lombard Pub. Facilities Corp.* may provide a road map for determining whether such issuers are eligible for Chapter 11.

Las Vegas Monorail

Las Vegas Monorail (LVMC) was created as a private, nonprofit corporation to construct and operate a monorail in Las Vegas. To fund the monorail construction, Nevada issued municipal bonds and lent the proceeds to LVMC.

LVMC agreed to repay the loan and pledged its net revenues for the repayment of the loan. To obtain tax-exempt status on the bonds, LVMC certified that it was an instrumentality of the state of Nevada and controlled by the governor. Importantly, the state was not liable on the bonds.

Financial difficulty resulting from poor ridership caused LVMC to resort to Chapter 11—which was challenged by the insurer of the bonds, claiming LVMC was a municipality not eligible for Chapter 11 relief.

In considering whether LVMC was eligible to be a Chapter 11 debtor, the bankruptcy court employed a three-prong test:

- Does it have any of the powers typically associated with sovereignty, such as eminent domain, the

taxing power or sovereign immunity?
- If such powers are absent or only weakly present, does it have a public purpose, and if so, what is the level of control exerted by the state or its agents?
- What is the state's own designation and treatment of the entity?

The court concluded LVMC was not a municipality, finding:

- LVMC was engaged in a public purpose, but not carrying out a public function;
- LVMC did not have the traditional governmental powers, such as the taxing power and eminent domain;
- The state was insulated from any losses arising from the bonds issued to finance the monorail; and,
- Nevada did not designate or treat LVMC as an instrumentality.

Lombard Public Facilities Corporation

The Lombard Public Facilities Corporation (LPFC) is an Illinois not-for-profit, authorized as a public facilities corporation pursuant to Illinois law to finance and construct the Westin Lombard Yorktown Center in the Village of Lombard.

LPFC financed the project by issuing tax-exempt municipal bonds, which was possible because LPFC constituted an instrumentality for federal tax purposes. These bonds were limited recourse obligations of LPFC and payable solely from revenues and other assets. The village's limited commitment to fund debt service shortfalls was subject to prior appropriation.

LPFC commenced a Chapter 11 case to implement the terms of an agreed upon restructuring necessitated by unfavorable market conditions. Like LVMC, LPFC's eligibility for Chapter 11 was challenged by two parties claiming LPFC was an instrumentality of the village.

With a focus on the village's actual control over the LPFC, the Illinois bankruptcy court determined that the LPFC:

- did not carry out a governmental function of the village (e.g., impose taxes, maintain a police force, provide water and sewage treatment);
- did not have a charter from the state recognizing it as a governmental body;
- was a commercial enterprise in competition with other hotels and convention centers; and instrumentality status for tax purposes was not dispositive.

The cash crunch caused by Covid-19 has caused LVMC to resort to Chapter 11 again, and LPFC skipped a portion of its debt payment in July 2020. But these are not isolated issues.

In the past few months, issuers, including the following, have provided notice of unscheduled draws on reserve accounts to meet current debt service obligations.

- Bayonne Local Redevelopment Authority (N.J.);
- Overland Park, Kan.;
- Clark County, Nev.;
- Franklin County Convention Facilities Authority (Ohio);
- Evergreen Park, Ill. (Senior Lien Limited Sales Tax Rev Bonds—Evergreen Plaza Development Project); and
- Economic Development Growth Engine for Memphis & Shelby County (Tenn.)

As reserve accounts continue to be drawn, the eligibility debate may not be hypothetical absent an increase in revenues and/or relief from Congress. Issuers and investors alike should evaluate

Chapter 11 eligibility, especially where it is assumed that an issuer is not eligible for any relief under the Bankruptcy Code because applicable state law does not authorize Chapter 9 filings.

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