

Two Recent Rulings Address Eligibility for Chapter 9 Bankruptcy Protection

Two recent rulings have provided significant guidance on the determination of whether an entity is eligible to be a debtor under Chapter 9 of the Bankruptcy Code. On April 26, 2010, the Bankruptcy Court for the District of Nevada issued a decision denying a motion to dismiss the Chapter 11 case of Las Vegas Monorail Company (LVMC) filed by Ambac Assurance Corp. *In re Las Vegas Monorail Company (Las Vegas Monorail)*. Ambac, which insured the bulk of the tax-exempt bonds issued by the State of Nevada to construct the monorail, alleged that LVMC was a municipality under the Bankruptcy Code and therefore ineligible to file under Chapter 11.

The Bankruptcy Code provides that only “a person that may be a debtor under chapter 7” may be a Chapter 11 debtor. Under section 101(41) of the Code, with limited exceptions, the definition of “person” specifically excludes a “governmental unit,” which in turn is defined in section 101(27) to include a “municipality.” Thus, if LVMC was a municipality it could not seek protection under Chapter 11.

Judge Bruce Markell initially recognized that there is no clear direction in the Code or relevant case law that would clarify when a particular organ of state government would be judged to be a “municipality” or not. Section 101(40) of the Code provides that the term “municipality” means a “political subdivision or public agency or instrumentality of a State.” The challenge, the court explained, was to further define these three terms. Judge Markell quickly concluded that LVMC is clearly not a “political subdivision,” such as a city, county, town, or village; nor is it a “public agency,” as it was formed under general nonprofit corporation statutes, rather than by the Nevada legislature. The only included term that might fit LVMC is “instrumentality of the State.”

Judge Markell then looked to legislative developments and how case law has evolved regarding Chapter 9 eligibility to determine the present meaning of “instrumentality of a State” within the definition of “municipality.”¹ After reviewing the history of federal statutes governing municipal insolvencies and relevant case law, Judge Markell distilled the determination as to whether an entity qualifies as an “instrumentality of a State” into three basic inquiries: (i) the extent to which the entity has traditional governmental attributes or engages in traditional governmental functions; (ii) the extent to which the state controls the entity’s operations, with elements that go to control of the state’s finances having more weight than elements that may simply be general regulation; and (iii) the extent to which the state itself categorizes the entity as a municipality or instrumentality. With respect to the first inquiry, LVMC was formed under general nonprofit corporation statutes rather than of a specific legislative enactment, demonstrating that LVMC does not possess traditional governmental attributes. Second, although the State of Nevada has general regulatory oversight over LVMC, such as veto power over its rates and budget, it does not exercise control of day-to-day operations. Third, Judge Markell found that although tax-exemption filings with Internal Revenue Service described LVMC

BEIJING
CHARLOTTE
CHICAGO
GENEVA
HONG KONG
LONDON
LOS ANGELES
MOSCOW
NEW YORK
NEWARK
PARIS
SAN FRANCISCO
SHANGHAI

WASHINGTON, D.C.

www.winston.com

¹ A municipality may file for protection under Chapter 9 of the Bankruptcy Code as long as it is “specifically authorized” by the state. See 11 U.S.C. § 109(c). As an aside, Judge Markell noted that in Nevada a municipality is specifically not authorized to file under Chapter 9; rather, Nevada has its own internal system to handle municipal insolvencies.

as an instrumentality of the state, Nevada does not so treat LVMC for any other purpose. Judge Markell considered that LVMC has no taxing powers, no power to issue obligations which bear tax-free interest,² and must apply to other Nevada state agencies for its licenses and permits. Therefore, Judge Markell concluded, LVMC was not an instrumentality of the state, and thus, not a municipality under the Bankruptcy Code. Consequently, LVMC was indeed eligible to file for Chapter 11.

A little over a month prior to the *Las Vegas Monorail* ruling, on March 22, 2010, the Bankruptcy Court for the Southern District of New York issued an Opinion and Order overruling objections of certain creditors to the Chapter 9 petition of New York City Off-Track Betting Corporation (OTB). *In re New York Off-Track Betting Corp. (NYC OTB)*. The objecting creditors argued that OTB could not satisfy the requirements to be a debtor under Chapter 9 of the Bankruptcy Code and that OTB did not file its petition in good faith.

Judge Martin Glenn examined whether OTB met the requirements under section 109(c) of the Bankruptcy Code to file for protection under Chapter 9. Section 109(c) requires that a Chapter 9 debtor:

1. is a municipality;
2. is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;
3. is insolvent;
4. desires to effect a plan to adjust such debts; and
5. a) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

b) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

c) is unable to negotiate with creditors because such negotiation is impracticable; or

d) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

Unlike Judge Markell in *Las Vegas Monorail*, Judge Glenn did not focus on whether or not OTB is a “municipality.” Judge Glenn quickly found that OTB was a “municipality” as it is a public benefit corporation “created by the State for the general purpose of performing functions essentially governmental in nature.” (In *NYC OTB*, the objecting creditors conceded that OTB is a “municipality” under the Bankruptcy Code, which could explain the limited treatment of the issue.)

The focus of the *NYC OTB* decision, rather, was the second of the section 109(c) requirements, whether OTB had sufficient authorization to file for Chapter 9 protection. Three months prior to its bankruptcy petition—and 30 years after the creation of OTB—the Governor of New York issued an Executive Order specifically authorizing OTB to file for bankruptcy protection under Chapter 9 of the Bankruptcy Code. The objecting creditors argued that this Executive Order did not meet the specific authorization requirement of section 109(c)(2) because it was not authorized by the New York state legislature. Judge Glenn, however, found that under New York law the governor possesses the power to authorize a Chapter 9 filing on behalf of the state. Further, he found that OTB met the final three section 109(c) requirements as well: (i) OTB was insolvent when it filed for Chapter 9 protection; (ii) it had expressed a desire to effect a plan to adjust its debts; and (iii) it had met each of the section 109(c)(5) requirements with respect to its creditors. Finally, Judge Glenn ruled that OTB filed for Chapter 9 protection in good faith after examining alternatives.

Although the *Las Vegas Monorail* and *NYC OTB* decisions may at first seem at odds in terms of whether a particular entity is a municipality or not, the inquiries in the two decisions are different. In *NYC OTB*, the focus is whether OTB was specifically authorized to file for bankruptcy and whether the governor’s Executive Order met the specific authorization requirement of section 109(c)(2), and the creditors did not challenge whether OTB was a “municipality” under section 101(40). However, even if the creditors in *NYC OTB* had challenged whether it is a municipality, Judge Glenn would likely have come to the same conclusion, as OTB is a public benefit corporation created by state statute, unlike LVMC, which was created under Nevada’s general

² The bonds that Ambac insured in *Las Vegas Monorail* were issued by a Nevada state agency rather than LVMC.

nonprofit corporation laws. Given OTB's authorization and creation by the New York State legislature, Judge Markell's analysis in *Las Vegas Monorail* confirms Judge Glenn's conclusion that OTB is a "municipality" within section 109(c)(2). Nor is there anything in Judge Glenn's decision to imply that he would not have come to the same conclusion as Judge Markell did in *Las Vegas Monorail*. Interestingly, because Nevada does not authorize municipalities to file under Chapter 9 of the Bankruptcy Code, had LVMC's Chapter 11 bankruptcy case been dismissed, LVMC would have no recourse other than to be subject to Nevada's state insolvency regime.

On May 10, 2010, Ambac and its court appointed rehabilitator appealed the *Las Vegas Monorail* decision. Assuming it is upheld, the decision is a welcome judicial guide to analyzing whether a particular organ of a state is a municipality under the Bankruptcy Code, and likely to be cited by courts addressing future controversies in this area. While of less general applicability, Judge Glenn's decision in *NYC OTB* provides direction in New York as to ability of the governor to authorize a municipality's filing under Chapter 9 where the legislature is silent in its enabling statute.

If you have questions concerning the items in this Briefing, or about restructuring and insolvency matters generally, please contact one of the following attorneys:

Chicago**(312) 558-5600**

Thomas F. Blakemore

Matthew J. Botica

Daniel J. McGuire

Brian I. Swett

Los Angeles**(213) 615-1700**

Justin E. Rawlins

Eric E. Sagerman

Rolf S. Woolner

New York**(212) 294-6700**

James Donnell

Samuel S. Kohn

Lawrence A. Larose

David Neier

Carey D. Schreiber

Steven M. Schwartz

Sarah L. Trum

San Francisco**(415) 591-1000**

Todd J. Dressel

John D. Fredericks

David A. Honig

Robert A. Julian

Richard A. Lapping

Randy Rogers

These materials have been prepared by Winston & Strawn LLP for informational purposes only. These materials do not constitute legal advice and cannot be relied upon by any taxpayer for the purpose of avoiding penalties imposed under the Internal Revenue Code. Receipt of this information does not create an attorney-client relationship. No reproduction or redistribution without written permission of Winston & Strawn LLP.