CHARTER SCHOOL BANKRUPTCY ELIGIBILITY UNDER THE "GOVERNMENTAL UNIT" EXCEPTION

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ABSTRACT

The question presented in this Note is whether public charter schools should be treated as "governmental units," as defined in § 101(27) of the United States Bankruptcy Code, for Chapters 11 or 7 bankruptcy eligibility purposes. This is an important topic for several reasons. First, public charter schools are rapidly expanding in the United States. Second, charter schools are relatively innovative institutions that operate through a complex system of public and private financing, and therefore, carry a risk of bankruptcy. Third, how a bankruptcy court chooses to classify a debtor charter school vis-à-vis the Bankruptcy Code's definition of "governmental unit" affects which type of bankruptcy relief, if any, is available to the debtor charter school. To date, charter school bankruptcies have been permitted to proceed under Chapters 11 or 7 bankruptcy without challenge. This Note argues that given an alignment of appropriate circumstances, a charter school could be rendered bankruptcy-remote on the basis of the Bankruptcy Code's "governmental unit" exception.

INTRODUCTION

Charter schools are publicly funded, but privately operated, schools that currently operate in forty-four states and the District of Columbia, Puerto Rico, and Guam.[1] They are formed by an agreement between charter operators and charter-authorizing entities like government bodies, educational institutions, or non-profit organizations.[2] Charter schools share similarities with traditional public schools in that they are tuition-free and open to the public (although many

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1. *See* Nicole Stelle Garnett, *Sector Agnosticism and the Coming Transformation of Education Law*, 70 VAND. L. REV. 1, 10, 13 (2017); *Key Facts About Charters*, CHARTER SCHS. PERSP., http://www.in-perspective.org/pages/introduction#sub1 (last updated 2018).

2. *See* Garnett, *supra* note 1, at 13.

charter schools admit students by lottery or by preferred treatment to local neighborhood children).[3] They are also bound by federal constitutional constraints that prevent them from discriminating on the basis of race, gender, religion, or disability.[4]

However, unlike traditional public schools, charter schools are not bound by all state and district education related rules and regulations.[5] For instance, a charter school may establish a longer school year for students or require different qualification levels for its teachers.[6] Charters are accountable to the legally binding charter agreement that sets out the rules and regulations of operation.[7] Given this flexibility, charter schools are regularly reviewed by their authorizing bodies (typically every three to five years).[8] Charters that do not meet the standards laid out in the agreement are at risk of having their charter revoked, often resulting in school closure.[9]

Significantly, charter schools are rapidly expanding in the United States. In fact, the United States Department of Education estimates that there were 6,855 charter schools operating in the United States in 2016, with more than 2.8 million enrolled students.[10] Additionally, the proportion of charter schools to all public schools was seven percent in the same year, and student enrollment in charter schools grew more than seventy percent from 2009–10 to 2015–16.[11] Projections further indicate that charter school enrollment will increase in the coming years.[12]

Given their growth and sizable capital throughout the United States, charter schools pose a financial risk in the event of a default on their debt obligations. Recently, in November 2019, two United States charter schools

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3. *See* Nicole Stelle Garnett, *Disparate Impact, School Closures, and Parental Choice*, 2014 U. CHI. LEGAL F. 289, 337–38, 338 n.209; Valerie Strauss, *How Charter Schools Choose Desirable Students*, WASH. POST (Feb. 16, 2013, 6:00 AM), https://www.washingtonpost.com/news/answer-sheet/wp/2013/02/16/how-charter-schools-choose-desirable-students/ [https://perma.cc/PEP9-9ZFK].

4. *See Key Facts About Charters*, *supra* note 1.

5. *See id.*

6. *See id.*

7. *See id.*

8. *See id.*

9. *See id.*

10. *See generally Digest of Education Statistics: Table 216.20. Number and Enrollment of Public Elementary and Secondary Schools, by School Level, Type, and Charter and Magnet Status: Selected Years, 1990–91 Through 2015–16*, NAT'L CTR. FOR EDUC. STAT. (2017), https://nces.ed.gov/programs/digest/d17/tables/dt17_216.20.asp?current=yes.

11. *See* NAT'L CTR. FOR EDUC. STATISTICS, *Public Charter School Enrollment*, *in* THE CONDITION OF EDUCATION (2018), https://nces.ed.gov/programs/coe/pdf/Indicator_CGB/coe_cgb_2018_05.pdf; *Key Facts About Charters*, *supra* note 1.

12. *See Key Facts About Charters*, *supra* note 1.

filed for bankruptcy in light of significant financial distress.[13] The Treeside Charter School (Treeside) in Provo, Utah filed for Chapter 11 bankruptcy to alleviate nearly half a million dollars of debt it owes to its creditors.[14] The Kwame Nkrumah Academy, Inc. (Kwame) filed for Chapter 7 bankruptcy with debts that include over six-hundred thousand dollars owed to the local public teachers' pension fund.[15] Upon filing for bankruptcy, Treeside and Kwame joined a group of nearly a dozen other public charter schools that have filed for Chapters 11 or 7 bankruptcy relief since 2010.[16] Given the financial volatility of many charter schools across the United States, the group is likely to add members in the future.

Curiously, none of the creditors involved in these public charter school bankruptcies challenged the debtor charter school's bankruptcy eligibility on the basis of the governmental unit exception. The United States Bankruptcy Code (the Code) provides that the debtor bears the burden of proving that it meets the applicable bankruptcy eligibility requirements.[17] Generally, in order to file under Chapters 11 or 7, the debtor entity must be a "person." However,

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13. *See* Courtney Tanner, *Utah Charter School Where Students Focused on Nature, Yoga, 'Love and Logic' Files for Bankruptcy*, SALT LAKE TRIB. (Nov. 14, 2019), https://www.sltrib.com/news/education/2019/11/14/utah-charter-school-where/; Becky Yerak, *Chicago Charter School Operator Files for Bankruptcy*, WALL STREET J. (Nov. 18, 2019, 3:38 PM), https://www.wsj.com/articles/chicago-charter-school-operator-files-for-bankruptcy-11574109490.

14. *See* Tanner, *supra* note 13.

15. *See* Yerak, *supra* note 13.

16. *See, e.g.*, Denise Smith Amos, *Charter School Bankruptcy Opens Some 'Closed' Books*, FLA. TIMES-UNION (July 1, 2015, 4:56 PM), https://www.jacksonville.com/article/20150701/NEWS/801248404; Angela Ruggiero, *Livermore Charter Schools File for Bankruptcy*, EAST BAY TIMES (Nov. 9, 2016, 11:47 AM), https://www.eastbaytimes.com/2016/11/09/livermore-charter-schools-file-for-bankruptcy/; Andrew Marra, *This Defunct Wellington Charter School Says It's Bankrupt. Its Ex-Teachers Are Still Fighting To Be Paid*, PALM BEACH POST (Mar. 27, 2019, 5:48 AM), https://www.palmbeachpost.com/news/20190327/this-defunct-wellington-charter-school-says-its-bankrupt-its-ex-teachers-are-still-fighting-to-be-paid; Noelle Kachinsky, *Macon Charter Academy Files For Chapter 11 Bankruptcy Protection*, WGXA (May 27, 2016), https://wgxa.tv/news/local/macon-charter-academy-files-for-chapter-11-bankruptcy-protection; Derek Staahl, *Phoenix Charter School to Close Due to 'Egregious Financial Mismanagement,'* AZFAMILY.COM (Mar. 21, 2018), https://www.azfamily.com/news/phoenix-charter-school-to-close-due-to-egregious-financial-mismanagement/article_16b7927a-0c74-5885-b524-8792bec9d3d4.html; Kyle Glazier, *California Charter School Operator Files For Chapter 11*, BOND BUYER (Nov. 10, 2016, 2:36 PM), https://www.bondbuyer.com/news/california-charter-school-operator-files-for-chapter-11; Bill Bush, *Columbus Charter School Sues State Over Its Planned Closing*, COLUMBUS DISPATCH (Apr. 19, 2018, 5:06 PM), https://www.dispatch.com/news/20180419/columbus-charter-school-sues-state-over-its-planned-closing.

17. *See The Bankruptcy Eligibility of Quasi-Government Entities*, CHAPMAN & CUTLER LLP (Feb. 5, 2018), https://www.chapman.com/insights-publications-Chapter_9_Chapter_11_Bankruptcy_Eligibility.html.

the Code's definition of a "person"[18] explicitly *prohibits* entities that are a "governmental unit."[19] The term "governmental unit" is defined in § 101(27) 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."[20] Consequently, if an entity is proven to be an "instrumentality" of a State or of a municipality, it would be barred from Chapters 11 or 7 bankruptcy relief.

The reason that governmental units are prevented from seeking Chapters 11 or 7 bankruptcy is that governments are different from traditional debtors.[21] First, "the taxation powers of governments are only indirectly analogous to individual or corporate sources of income" and the government's "obligation to [its] citizens [has] no private analogue."[22] Second, the "federal interference with state and local governance via bankruptcy raises unique constitutional concerns."[23] Allowing political subdivisions of a State to petition for bankruptcy without specific State authorization from their respective state governments would infringe on the State's sovereignty over its subdivisions.[24]

Accordingly, if a governmental unit wished to file for bankruptcy, it would have to file under the municipal provisions of Chapter 9.[25] However, being classified as a governmental unit does not guarantee access to Chapter 9. There are two primary reasons for this. First, Chapter 9 is only available to governmental units that are also a "municipality," defined in the Code as a "political subdivision or public agency or instrumentality of a State."[26] Therefore, an entity can find itself to be bankruptcy-remote if it is classified as a governmental unit for Chapters 11 or 7 eligibility purposes, but not classified

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18. *Compare* 11 U.S.C. § 109(b) (2018) ("A person may be a debtor . . . ."), *with id.* § 101(41)("The term 'person' . . . does not include [a] governmental unit . . . .").

19. *Id.* § 101(41).

20. *Id.* § 101(27) (emphasis added). The term "governmental unit" can be found throughout the Code, each time representing distinct policy considerations. For instance:

> § 362(b)(4) provides that the automatic stay does not apply to the exercise of the "police and regulatory power of a governmental unit." Section 106 provides that "sovereign immunity is abrogated as to a governmental unit" as set forth in that section. Section 523(a)(7) provides an exception to the discharge of individual debtors for certain debts payable to "governmental units." Section 525(a) provides that a "governmental unit" may not discriminate against persons solely because of a bankruptcy or pre-bankruptcy insolvency.

Marvin E. Sprouse III, *Defining the "Governmental Unit,"* AM. BANKR. INST. J. Apr. 2004, at 8, https://www.abi.org/abi-journal/defining-the-governmental-unit.

21. *See* Ky. Emps. Ret. Sys. v. Seven Ctys. Servs., Inc., 901 F.3d 718, 724 (6th Cir. 2018).

22. *Id.*

23. *Id.*

24. *See* Richard L. Epling et al., *Monorail, Monorail, Monorail: Chapter 9 and Restructuring Issues Relating to Municipal Authorities*, NORTON J. BANKR. L. & PRAC., Mar. 2011, at 2 art. 1.

25. *See id.*

26. 11 U.S.C. § 101(40) (2018).

as a municipality for Chapter 9 eligibility purposes.[27] Second, any Chapter 9 petition requires specific State authorization which is often difficult, if not statutorily impossible, to acquire.[28] Given the restrictive nature of Chapter 9 eligibility, it is not surprising that charter schools have at this point only petitioned for Chapters 11 or 7 bankruptcy.

Yet, a judicially unanswered question lingers: what happens if a creditor challenges a charter school's Chapter 11 or 7 petition on the basis that the debtor entity is an ineligible governmental unit? While the Code offers a definition of "governmental unit," it does not provide a definition of "instrumentality." Expectedly, defining "instrumentality" has proven to be an onerous task for judges both in and out of bankruptcy court. How judges choose to define and interpret "instrumentality" is likely to be a crucial factor for the survival of a Chapter 11 or 7 bankruptcy petition filed by a quasi-governmental entity (QGE), such as a public charter school.

Although there has been no legal challenge to date regarding a charter school's eligibility for Chapters 11 or 7 bankruptcy on the basis of the governmental unit exception, one may come up in the future. This Note explores the potential outcomes of such a challenge. Part I of this Note will examine how courts have treated similarly situated quasi-governmental entities in light of a governmental unit exception challenge. This Part will illustrate that courts have generally adopted a highly fact-specific totality-of-the-circumstances approach in determining whether a quasi-governmental entity is a governmental unit. Part II will assess the likelihood of a public charter school meeting the definitional standard of "governmental unit" in light of the cases described in Part I. Specifically, this Part will conclude that, given appropriate circumstances, it is possible that a bankruptcy court may classify a public charter school as a governmental unit.

I. THE BANKRUPTCY ELIGIBILITY OF QUASI-GOVERNMENTAL ENTITIES

There is limited case law involving the bankruptcy eligibility of quasi-governmental entities. The five primary cases to date that are on point are described in detail in this section. Three of the decisions resulted in a finding that the debtor QGE *was not* a governmental entity, and therefore, permitted to proceed under Chapter 11. Two of the decisions resulted in a finding that the debtor QGE *was* a governmental entity, and therefore, not permitted to proceed under Chapter 11. An analysis of these cases will illustrate that determining whether an entity is a governmental unit is a highly fact-specific task and may result in contradictory or inconsistent conclusions. To make this easier to see,

27. *See generally Sixth Circuit Weighs in on the Meaning of "Governmental Unit,"* CHAPMAN & CUTLER LLP (Oct. 4, 2018) [hereinafter *Meaning of "Governmental Unit"*], https://www.chapman.com/media/publication/891_Chapman_Sixth_Circuit_Governmental_Unit_100418.pdf (describing a circumstance in which a bankruptcy court may find an entity a governmental unit but not a municipality, thus rendering it ineligible for bankruptcy relief and, thus, bankruptcy remote).

28. *See* Epling et al., *supra* note 24.

this Part is divided into two sections. The first section will look at the three cases that resulted in a finding that the debtor entity was not a governmental unit. The second section will look at the two cases that resulted in a finding that the debtor entity was a governmental unit.

A. Court Determined Debtor Entity Was Not a "Governmental Unit"

1. *In re Las Vegas Monorail Co.*[29]

In 2010, the Las Vegas Monorail Company (LVMC) filed for Chapter 11 bankruptcy after it defaulted on its bond obligations.[30] A group of creditors challenged LVMC's Chapter 11 petition on the grounds that the entity was, in fact, an instrumentality of the State and therefore ineligible for Chapter 11 relief.[31] The Nevada Bankruptcy Court noted that "statutory or caselaw guidance on what constitutes an instrumentality, or even a municipality, is scarce."[32] With no specific guidance from the Code, Judge Markell's lengthy opinion dissected the meaning of "instrumentality" in light of its plain meaning, legislative history, and practical implications. Based on this examination, Judge Markell adopted a factor-based test to determine whether LVMC was an instrumentality of the State.[33] The three factors that were evaluated were: "(1) whether the entity in question ha[d] traditional governmental attributes, or engage[d] in traditional governmental functions; (2) the extent of state control over the entit[y's] attributes and functions; and . . . (3) the state categorization of the entity in question."[34] Applying these factors, the court determined that the LVMC was *not* an instrumentality of the State, and thus, not a governmental unit.

First, the court drew a distinction between entities that provide a traditional governmental function and those that merely assist a larger public purpose while being subject to State regulation. For instance, the court noted that "[a] limited measure of public control, regulation or oversight simply does not, by itself, make an entity a public agency. Otherwise, heavily regulated industries, such as casinos and taxi cabs, would be municipalities."[35] Second, the court determined that because the LVMC did not "operate[] in place of the State" but, rather, was "simply subject to regulation," the LVMC was not sufficiently controlled by the State.[36] Third, because Nevada's statutory definition of "local government" makes the power to tax the *sine qua non* of

29. *In re* Las Vegas Monorail Co., 429 B.R. 770 (Bankr. D. Nev. 2010).

30. *Las Vegas Monorail Co.*, 429 B.R. at 774.

31. *Id.* at 770.

32. *Id.* at 775.

33. *Id.* at 788–89.

34. *Bankruptcy Eligibility Ruling:* In re Lombard Public Facilities Corporation, CHAPMAN & CUTLER LLP (Jan. 11, 2018) [hereinafter *Bankruptcy Eligibility Ruling*], https://www.chapman.com/media/publication/834_Chapman_Bankruptcy_Eligibility_Ruling_011118.pdf.

35. *Las Vegas Monorail Co.*, 429 B.R. at 785.

36. *Id.* at 797–98.

municipal status, the LVMC would not be considered a municipality from the State's perspective.[37] Thus, based on the application of these three factors, the bankruptcy court determined that the LVMC was not a governmental unit and could therefore be a debtor under Chapter 11.

2. *In re Lombard Public Facilities Corp.*[38]

Shortly after the *Las Vegas Monorail Co.* decision, Judge Jacqueline P. Cox of the U.S. Bankruptcy Court for the Northern District of Illinois adopted a similar factor-based standard in *Lombard*.[39] In *Lombard*, the debtor was incorporated in 2003 by the Village of Lombard, Illinois as a not-for-profit corporation. The debtor entity was created to act on behalf of the village to finance and construct a hotel and convention center.[40]

However, due to revenue shortfalls, the debtor became financially distressed and filed for Chapter 11 bankruptcy.[41] In response, 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 for Chapter 11 relief. Similar to *Las Vegas Monorail Co.*, the *Lombard* court's decision hinged on the interpretation and application of the definition of "instrumentality."[42]

In line with the decision of *Las Vegas Monorail Co.*, the *Lombard* court focused on the same three factors identified in that case.[43] First, the court determined that building a convention center was not a traditional governmental function. The court reasoned that although "[g]enerating and encouraging economic activity is worthwhile, . . . it is not a core government function."[44] Second, the court determined that the government did not possess sufficient control over the debtor entity.[45] Although the debtor entity was subject to State regulation, that alone was not enough to demonstrate control.[46] Significantly, the court noted that sufficient control could be demonstrated if the entity was protected by the State's tort immunity provisions.[47] Finally, the court determined that the village's own categorization of the debtor as a governmental unit was not dispositive, especially because the Illinois Department of Revenue

37. *Id.* at 799.

38. *In re* Lombard Pub. Facilities Corp., 579 B.R. 493 (Bankr. N.D. Ill. 2017).

39. *Id.* at 494.

40. *Id.* at 495.

41. *Id.* at 495–99.

42. *Id.*

43. *Id.*; *see also Bankruptcy Eligibility Ruling*, *supra* note 34 ("In line with the decision of *In re Las Vegas Monorail Co.*, the [*Lombard*] [c]ourt'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 entit[y's] attributes and functions; and finally (3) the state categorization of the entity in question.") (citation omitted).

44. *Lombard*, 579 B.R. at 501.

45. *Id*. at 498–501.

46. *Id.*

47. *Id.* at 496.

had previously held that the entity was not a governmental unit.[48] Therefore, the court determined that the debtor was not a governmental unit and, thus, an eligible debtor under Chapter 11.[49]

3. *Kentucky Employees Retirement System v. Seven Counties Services, Inc.*[50]

Recently, in 2018, the Sixth Circuit Court of Appeals became the latest court to adopt a totality-of-the-circumstances approach when it was asked to determine whether a nonprofit organization, the Seven Counties Services, Inc. (SCS) was a governmental unit and, therefore ineligible for Chapter 11 relief under the Code.[51]

The debtor, SCS, petitioned for Chapter 11 relief in order to cancel and reject its contractual obligations to the Kentucky Employees Retirement System (KERS).[52] KERS subsequently sought dismissal of the Chapter 11 petition, arguing that SCS was an instrumentality of the Commonwealth of Kentucky, and therefore, ineligible for Chapter 11 reprieve.[53]

The Sixth Circuit focused on three primary issues: "(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."[54] However, unlike *Las Vegas Monorail Co.* and *Lombard*, the Sixth Circuit placed greater emphasis on governmental control.[55]

While stating that daily control would likely be enough to designate a debtor entity as a governmental unit, the court maintained that such a "granular level of control is not necessary."[56] Instead, the Sixth Circuit applied the following five control factors: "(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)

48. *Id.* at 498.

49. *Id.* at 498–500; *see also Bankruptcy Eligibility Ruling*, *supra* note 34 (describing what the *Lombard* court focused its decision on: (1) "No Full Faith and Credit Pledge," (2) "Project Not Actively Carrying Out Essential Governmental Function," (3) "No Agency," (4) "Being 'Subject to' State Law Is Insufficient," (5) "A Board Comprised of Municipal Employees May Be Insufficient," (6) "Inclusion in Municipal Financial Statements Is Insufficient," and (7) "Past State Court Rulings Have Persuasive Value").

50. Ky. Emps. Ret. Sys. v. Seven Ctys. Servs., Inc., 901 F.3d 718 (6th Cir. 2018).

51. *Id.*

52. SCS filed for Chapter 11 bankruptcy because as employer contribution rates skyrocketed up to twenty-four percent in 2013, the SCS could no longer sustain operations at that contribution level. *See id.* at 724.

53. *Id.* at 718–19.

54. *Meaning of "Governmental Unit," supra* note 27.

55. *Seven Ctys.*, 901 F.3d at 726.

56. *Id.* at 727.

whether and how the entity receives government funding; and (5) whether the government can destroy the entity."[57]

Although the court noted that SCS was "an unusual entity" with some characteristics that belong to a state agency and some that do not, the Sixth Circuit ultimately found that there was not enough governmental control over SCS to conclude that it was a State instrumentality.[58] Applying the five control factors, the Sixth Circuit determined: "The Commonwealth of Kentucky did not create [SCS], does not in the normal course of events choose its leadership, does not govern its operations through an enabling statute, does not fund it through a mechanism that is normally reserved for public entities, and cannot unilaterally destroy it."[59] Moreover, the court added that the analysis of whether an entity is a governmental unit may include other factors as well. For instance, the court noted that "[a] showing that Seven Counties possessed commonly recognized governmental attributes, for example, would give pause."[60] Still, the court determined that SCS did not possess such attributes.

Significantly, the lengthy dissent in *Seven Counties* raised an important consideration regarding the issue of preserving State sovereignty.[61] Specifically, the dissenting opinion argued that rather than a totality-of-the-circumstances approach, the analysis should be limited to whether the debtor entity is: (1) an agent that carries out one or more traditional governmental functions, and (2) controlled by a government.[62] Essentially, the dissent argued that there should be a broader net of classification in order to protect the sovereignty of the State.

B. Court Determined Debtor Entity Was a "Governmental Unit"

In the three cases described above, the courts ultimately classified the debtor QGEs as non-governmental entities, and therefore, eligible for Chapter 11 relief. Based on their highly-fact specific and factor-based analyses, the three courts determined that their respective debtor QGEs were sufficiently isolated from the sovereign to escape a governmental unit classification. This Part will examine two cases where it was determined that the debtor entity was, in fact, a governmental unit. Specifically, this Part will look at *In re Northern Mariana Islands Retirement Fund*[63] and *In re Hospital Authority*.[64]

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57. *Meaning of "Governmental Unit," supra* note 27.

58. *Seven Ctys.*, 901 F.3d at 729.

59. *Id.*

60. *Id.* at 730.

61. *Id.* at 733.

62. *Id.* at 734–35.

63. *In re* N. Mar. I. Ret. Fund, No. 12-00003, 2012 WL 8654317 (D. N. Mar. I. June 13, 2012).

64. *In re* Hosp. Auth., No. 12–50305, 2012 WL 2905796 (Bankr. S.D. Ga. July, 3 2012).

1. *In re Northern Mariana Islands Retirement Fund*

In 2012, the Northern Mariana Islands Retirement Fund (the Fund) became the first quasi-governmental retirement fund to file for bankruptcy.[65] The Fund filed for Chapter 11 bankruptcy after facing years of financial trouble, significantly due to mismanagement of payments.[66] The primary issue decided in *Northern Mariana Islands* was whether the Fund was a governmental unit, and therefore, ineligible to file for Chapter 11 bankruptcy. This was a significant case for two primary reasons. First, it raised an important policy consideration with respect to rendering an entity bankruptcy remote. For instance, the Fund claimed that public policy considerations warranted a finding that it was eligible for Chapter 11 relief. Specifically, the Fund noted that Chapter 9 was not an available option because the Fund "operates within a territory of the United States rather than a 'State' as that term is used in Bankruptcy Code Section 101(52)."[67] Additionally, the Fund stated that if it was deemed ineligible for Chapter 11 relief, it would "'fall[] between the cracks' of the Bankruptcy Code."[68] Second, the case raised an important concern regarding the future bankruptcy options of similarly situated pension funds. For instance, Professor David Skeel of the University of Pennsylvania Law School described the case as one that could "set a key precedent for other funds."[69] Specifically:

> "Folks who do not want pension funds to be able to file for bankruptcy or to restructure are probably watching with terror, . . . Folks who think there is no alternative but to figure out a way to restructure the pension, I think, are watching to see if this is another avenue."[70]

Those folks who did not want pension funds to be able to file for bankruptcy were met with relief when the District Court for the Northern Mariana Islands held that the Fund was, indeed, a governmental unit.[71] Although the court went into a fact-specific inquiry about the level of control and oversight over the Fund, it placed its principal emphasis elsewhere. In reaching its decision, the court appeared to place significant emphasis on the legislative intent to define the term "governmental unit" in the "broadest

65. *N. Mar. I. Ret. Fund*, 2012 WL 8654317, at *1.

66. *Id.*

67. Marvin Mills, *Small Island Fund, Big Bankruptcy Wave – U.S. Public Pension Fund Deemed Ineligible to Be a Chapter 11 Debtor*, WEIL BANKR. BLOG (July 27, 2012), https://business-finance-restructuring.weil.com/pre-filing-considerations/small-island-fund-big-bankruptcy-wave-u-s-public-pension-fund-deemed-ineligible-to-be-a-chapter-11-debtor/ (quoting the Northern Mariana Islands Retirement Fund's response to the motion to dismiss).

68. *Id.* (alteration in original).

69. Caitlin Kenney, *Judge Says Pension Fund Can't Seek Bankruptcy Protection*, NPR (June 5, 2012, 6:00 AM), https://www.npr.org/sections/money/2012/06/05/154302347/judge-says-pension-fund-cant-seek-bankruptcy-protection.

70. *Id.* (quoting David Skeel).

71. *N. Mar. I. Ret. Fund*, 2012 WL 8654317, at *4.

sense."[72] The court stated, "[r]eading the term 'governmental unit' in the broadest sense, as Congress intended . . . I hold that the Fund is an 'instrumentality' of the Commonwealth."[73]

Upon defining the scope of "governmental unit" in the "broadest sense," the court considered various facts about the debtor that pointed towards it being an instrumentality. Specifically, the court noted that:

> The government formed the Fund as a means of carrying out the government's obligations to its current and retired employees. Providing compensation and benefits to government employees is a quintessential governmental function. This is particularly true in the Commonwealth, where government employees' and retirees' pension rights enjoy constitutional protection.
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> . . . .
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> Further, the Commonwealth has significant ongoing influence over the Fund. The governor appoints its trustees, the legislature specifies (and from time to time changes) to whom the Fund must pay benefits and in what amounts, and, perhaps most importantly, the government provides (or rather, is supposed to provide) virtually all of its funding and resources.[74]

In its conclusion, the court appeared to understand the ramifications of its decision in relation to the Fund's "intolerable position."[75] Because the Fund was classified as a governmental unit it was barred from Chapter 11, but because it could not be classified as a municipality, it was also barred from Chapter 9.[76] Reflecting on this unusual situation, the court stated:

> The trustees' attempt to find a solution to this dilemma is creative and praiseworthy even though it cannot succeed. Congress did not intend that the Bankruptcy Code could solve all problems, least of all the financial problems of governmental units. The dismissal of this case will leave the Fund and its beneficiaries at the mercy of the Commonwealth government, but Congress intended that the local government, rather than a federal court, should address such problems.[77]

Notwithstanding the decision of *Northern Mariana Islands*, it is unclear how other courts would consider the policy implications of rendering an entity bankruptcy remote. It is possible that another court may look more favorably on granting Chapter 11 entry if the entity in question would also be barred from Chapter 9. Yet, in the same year as the *Northern Mariana Islands* decision, the United States Bankruptcy Court for the Southern District of Georgia reached a similar conclusion.

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72. *Id.* at *2.
73. *Id.*
74. *Id.*
75. *Id.* at *3.
76. *Id.*
77. *Id.*

2. *In re Hospital Authority*

In 2012, the Hospital Authority of Charlton County (the Hospital) sought to convert its Chapter 9 bankruptcy petition to Chapter 11.[78] The court had to determine whether the Hospital was a governmental unit, specifically, whether the Hospital was an instrumentality of Charlton County.[79] Similar to *Northern Mariana Islands*, the *In re Hospital Authority* court placed significant emphasis on the legislative intent to define "governmental unit" in the "broadest sense."[80] Specifically, the court stated, "[h]ere . . . the question is not whether the Hospital Authority is a municipality, but rather whether it is a governmental unit. The definition of 'governmental unit' is broader than the definition of 'municipality.'"[81] However, the court found the three factors outlined by *Las Vegas Monorail Co.* to be relevant and used them to determine whether the Hospital was a governmental unit.[82] Unlike *Las Vegas Monorail Co.*, the *In re Hospital Authority* court evaluated the factors under a broader scope.

First, the court evaluated whether the Hospital possessed attributes that traditional governmental entities typically possess. Here, the court described such attributes to include: "that it is a creature of specific legislative enactment, that it has sovereign immunity, that it may exercise the right of eminent domain, that it is tax-exempt, that it has the power to tax, and that it receives tax revenues."[83] Although the court determined that the Hospital only possessed two of these attributes, namely that it was the creature of specific legislative enactment and that it was tax-exempt, the court concluded that it *did* possess sufficient traditional governmental attributes to be considered a governmental unit.[84]

Next, the court examined whether the Hospital was subject to control by a public authority, State, or municipality. Here, the court noted that the governing board of the Hospital was appointed by Charlton County and that the Hospital was required to give notice to Charlton County in the event of a sale.[85] Therefore, the court concluded that the extent of the County's control over the Hospital made it a governmental unit.[86]

Third, the court considered the State's own classification or description of the Hospital. Here, the court easily concluded that the Hospital was a governmental unit by noting the Supreme Court of Georgia's description of

78. *In re* Hosp. Auth., No. 12–50305, 2012 WL 2905796, at *1 (Bankr. S.D. Ga. July, 3 2012).

79. *Id.*

80. *Id.* at *5.

81. *Id.* at *6.

82. *Id.*

83. *Id.*

84. *Id.* at *6–7.

85. *Id.* at *7–8.

86. *Id.*

hospital authorities as "instrumentalities created by the State and county for a special purpose."[87]

Predictably, the court ultimately determined that the Hospital was a governmental unit, and, therefore, barred from Chapter 11 relief.[88] Similar to *Northern Mariana Islands*, the court lamented the fact that the authority would not find a safe harbor in either Chapters 11 or 9 bankruptcy, stating, "[t]he reality is that not every entity is entitled to relief from its debts through bankruptcy."[89]

II. CHARTER SCHOOLS AS "GOVERNMENTAL UNITS"

Intuitively, one would think that charter schools are not "governmental units" because they are operated by private entities and do not possess certain traditional sovereign powers such as the authority to levy taxes or exercise eminent domain. However, based on the various factors evaluated in the cases described above, it may be possible, given an appropriate alignment of the factors, to convince a bankruptcy court that a public charter school is an "instrumentality" of a State, and thus, a "governmental unit."

This Part looks into how public charter schools fit into the various factors considered by the cases cited above, including (1) whether the entity fills a traditional governmental function; (2) whether the entity possesses traditional governmental attributes; (3) whether the State possesses sufficient control over the entity; and (4) whether the State categorizes the entity as governmental.

It is important to recognize, however, that not all charter schools are the same. Significantly, (1) charter-school-authorizing laws vary from state to state; (2) revenue-raising mechanisms vary from charter to charter; and (3) the level of government oversight varies from state to state.[90] Therefore, this section will examine the characteristics that generally apply to most charter schools in the United States. That being said, some of the qualities referenced below may not be applicable in all cases.

A. Factor 1: Traditional Governmental Function

The first factor would examine whether public charter schools carry a traditional governmental function. *Northern Mariana Islands* provides relevant guidance in answering this question. In that case, the court evaluated whether a retirement fund performed a traditional governmental function. In its analysis, the court noted that providing compensation and benefits to government employees was a "quintessential governmental function," especially because "government employees' and retirees' pension rights enjoy constitutional protection."[91]

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87. *Id.* at *8.

88. *Id.*

89. *Id.* at *9.

90. *See* Garnett, *supra* note 3; Strauss, *supra* note 3.

91. *In re* N. Mar. I. Ret. Fund, No. 12-00003, 2012 WL 8654317, at *2 (D. N. Mar. I. June 13, 2012).

Similarly, children in every state enjoy a constitutionally protected right to an education. In fact, every state in the United States carries a constitutional provision to provide for a system of free public education.[92] For instance, New York's constitution requires that "[t]he legislature shall provide for the maintenance and support of a system of free common schools, wherein all the children of this state may be educated."[93]

In this regard, it can be argued that charter schools are an instrumentality of the State created for the sole purpose of furthering the State's constitutional responsibility of providing free public education. In fact, public charter schools share foundational similarities with traditional public schools. They do not charge tuition; they are held to the same academic accountability measures as traditional schools; and they receive public funding similarly to traditional schools.[94]

Additionally, because forty-four states have some form of charter-authorizing law, it appears that state governments recognize the public benefit of having school choice. For instance, Delaware's charter-authorizing law provides that charter schools are intended to:

> [I]mprove student learning; encourage the use of different and innovative or proven school environments and teaching and learning methods; provide parents and students with measures of improved school and student performance and greater opportunities in choosing public schools within and outside their school districts; and to provide for a well-educated community.[95]

Where traditional public schools are underperforming, public charter schools help fill the quality gap, and, therefore, assist the State in its constitutional duty to provide for a system of public education.

Moreover, unlike the monorail in *Las Vegas Monorail Co.* and the convention center construction entity in *Lombard*, it can be argued that public charter schools are not *merely assisting* in a public purpose—they are *actually performing* the public purpose. In fact, in the city of New Orleans, ninety-three percent of the city's forty-eight thousand public school students are enrolled in

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92. *See, e.g.*, CAL. CONST. art. IX, § 1 ("A general diffusion of knowledge and intelligence being essential to the preservation of the rights and liberties of the people, the Legislature shall encourage by all suitable means the promotion of intellectual, scientific, moral, and agricultural improvement."); IND. CONST. art. VIII, § 1 ("Knowledge and learning, generally diffused throughout a community, being essential to the preservation of a free government; it shall be the duty of the General Assembly to encourage, by all suitable means, moral, intellectual, scientific, and agricultural improvement; and to provide, by law, for a general and uniform system of Common Schools, wherein tuition shall be without charge, and equally open to all."); KAN. CONST. art. VI, § 1 ("The legislature shall provide for intellectual, educational, vocational and scientific improvement by establishing and maintaining public schools, educational institutions and related activities which may be organized and changed in such manner as may be provided by law."); N.Y. CONST. art. XI, § 1.

93. N.Y. CONST. art. XI, § 1.

94. *See* Garnett, *supra* note 1.

95. DEL. CODE ANN. tit. 14, § 501 (West 2019).

charter schools.[96] In Detroit, over fifty percent of public school students are enrolled in charter schools.[97] In these cities, and many more across the nation, charter schools have effectively stepped into the shoes of the government to carry out the State's constitutional duty to provide education for its residents. In this regard, it would be difficult to argue that these charter schools are not performing a traditional governmental function.

However, in several other states, charter schools are less likely to be seen as performing a traditional governmental function. In twenty-three states that authorize charter schools, the percentage of public school students enrolled in charter schools is less than five percent.[98] For instance, in Iowa, there are only three active charter schools, with an enrollment of less than four hundred students.[99] In these states, arguing that charter schools have effectively stepped into the shoes of the government may be less persuasive to a court.

B. Factor 2: Traditional Governmental Attributes

The second factor would examine whether a public charter possesses attributes that traditional governmental entities typically possess.

> Attributes that tend to establish that an entity is governmental in nature include: that it is a creature of specific legislative enactment; that it has sovereign immunity; that it may exercise the right of eminent domain; that it is tax-exempt; that it has the power to tax; and that it receives tax revenues.[100]

Here, public charter schools generally satisfy three of the six attributes. First, public charter schools are creatures of specific legislative enactment. In fact, forty-four states have charter enabling laws that permit the creation of public charter schools.[101] Second, public charter schools may qualify as tax-exempt entities.[102] Third, public charter schools receive tax revenues, often through state and federal educational funding.[103]

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96. *See Key Facts About Charters*, *supra* note 1; *see also* Wilborn P. Nobles III, *Is an All Charter School System Really the Way to Go?*, N.Y. TIMES (Dec. 13, 2018), https://www.nytimes.com/2018/12/13/us/is-an-all-charter-school-system-really-the-way-to-go.html.

97. *See Key Facts About Charters*, *supra* note 1.

98. *See* NAT'L CTR. FOR EDUC. STATISTICS, *supra* note 11.

99. *See* HUNT KEAN LEADERSHIP FELLOWS, SCHOOL CHOICE STATE SUMMARY IOWA (2015), http://www.hunt-institute.org/wp-content/uploads/2015/04/ChoiceSummary_Iowa.pdf.

100. *In re* Hosp. Auth., No. 12–50305, 2012 WL 2905796, at *6 (Bankr. S.D. Ga. July, 3 2012).

101. *See Key Facts About Charters*, *supra* note 1.

102. *See Increased IRS Scrutiny of Charter Schools Operated by For-Profit Management Companies*, LEWIS ROCA ROTHGERBER CHRISTIE LLP (June 18, 2012), https://www.lrrc.com/Increased-IRS-Scrutiny-of-Charter-Schools-Operated-by-For-Profit-Management-Companies-06-18-2012.

103. *See id.*

Some public charter schools possess additional governmental attributes as well. Significantly, two recent state court decisions asserted that charter schools are protected under their respective State's Tort Claims Act (TCA).[104] This is particularly noteworthy because the lack of TCA protection was a principal factor in *Lombard*.[105] These two TCA cases will be discussed in more detail below under factor four—State categorization. Additionally, public charter school employees are typically included in state public pension plans.[106] Moreover, some states exempt charter schools from local zoning ordinances, a power that is typically reserved solely for sovereign entities.[107] These characteristics may be enough to sway a bankruptcy court, especially in light of the *In re Hospital Authority* case, where similar traditional governmental attributes were found.[108]

On the other hand, if a court determines that the power to tax or exercise eminent domain are the principal traditional governmental attributes to consider, then a public charter school will likely not be characterized as a governmental unit.[109] Because the totality-of-the-circumstances[110] approach varies from court to court, whether a public charter school meets the "traditional governmental attributes" standard is difficult to predict.[111]

C. Factor 3: Extent of State Control

The third factor would examine whether the entity is subject to control by a public authority, State, or municipality. The Sixth Circuit placed significant emphasis on this factor and provided the five guiding factors described in Part I to assess the extent of State control over an entity.

Conveniently, the Internal Revenue Service (IRS) applied each of these factors when it had to determine whether public charter schools were instrumentalities of the State, and thus, qualified for public pension enrollment.[112] In its analysis, the IRS focused on one primary question: what

104. *See* LTTS Charter Sch., Inc. v. C2 Constr., Inc., 342 S.W.3d 73 (Tex. 2011); *see also* Kreutzer v. Aldo Leopold High Sch., 409 P.3d 930 (N.M. Ct. App. 2017).

105. *See In re* Lombard Pub. Facilities Corp., 579 B.R. 493 (Bankr. N.D. Ill. 2017).

106. *50-State Comparison: Charter Schools: Do Teachers in a State's Charter Schools have Equal Access to the Public School Teachers' Retirement System?*, EDUC. COMMISSION STS. (Jan. 2018), http://ecs.force.com/mbdata/mbquestNB2C?rep=CS1723.

107. *See* Act of May 2, 1996, ch. 356, 1996 Ariz. Sess. Laws 1913, 1917 § 3 (classifying charter schools as public schools for purposes of assessing zoning fees, site plan fees, and development fees and providing that no political subdivision of the State may enact or interpret any law, rule, or ordinance in a manner that conflicts with the provision).

108. *See In re* Hosp. Auth., No. 12–50305, 2012 WL 2905796 (Bankr. S.D. Ga. July, 3 2012).

109. *See id.*

110. *See* Ky. Emps. Ret. Sys. v. Seven Ctys. Servs., Inc., 901 F.3d 718 (6th Cir. 2018).

111. *See In re Hosp. Auth.*, 2012 WL 2905796.

112. *See Memorandum re Federal Tax Law Standards for Evaluating "Governmental Status" of Charter Schools for Purposes of Participation in Governmental Pension Plans*, ORRICK (2014), http://www.publiccharters.org/sites/default/files/migrated/wp-

degree of control does the federal or state government have over the organization's everyday operations?[113] To answer this question, the IRS applied the following factors:

> (1) [W]hether there is specific legislation creating the organization;
>
> (2) the source of funds for the organization;
>
> (3) the manner in which the organization's trustees or operating board are selected; and
>
> (4) whether the applicable governmental unit considers the employees of the organization to be employees of the applicable governmental unit.[114]

Applying these factors, the IRS determined that public charter schools were instrumentalities of the State, and therefore, qualified to enroll in public pension plans.[115] Specifically, the IRS noted that:

> (1) The Licensing Entity controlled the make-up and performance of charter school employees by reviewing complaints against a charter school, granting or denying charters, auditing charter schools and imposing reporting requirements on charter schools.
>
> (2) Charter school teachers were required to be certified like other public school teachers.
>
> (3) Charter schools were required to perform the same public education purpose as other public schools and meet or exceed performance standards set forth in the school's charter . . . .
>
> (4) Charter schools were required to submit an annual report including measures of comparative academic and fiscal performance.
>
> (5) [The State] could investigate a charter school for violations and . . . can take remedial action it deems necessary including revoking the charter.
>
> (6) Charter schools were required to renew their charters, and such charters could be terminated.[116]

Given the in-depth analysis provided by the IRS regarding the level of governmental control over public charter schools, it is possible that a bankruptcy court will similarly conclude that public charter schools are State instrumentalities. Of course, the charter school characteristics described above are not applicable in all states. Therefore, a bankruptcy court would have to undertake a similar fact-specific inquiry into the extent of State control over the charter school in question.

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content/uploads/2014/09/Memo-Federal-Tax-Law-Standards-for-Evaluating——Governmental-Status——of-Charter-Schools.pdf.

113. *See id.*

114. *Id.* at 2.

115. *See id.*

116. *Id.* at 3.

D. Factor 4: State Categorization

The fourth factor would examine the State's own classification or description of charter schools. Here, public charter school classifications vary from state to state.[117] However, several state legislatures have identified charter schools as being part of the state-wide public school system.[118] For instance, Arizona's charter enabling law provides that:

> [A] charter school is subject to the same level of oversight and the same rules, hearing requirements, application requirements, ordinances, limitations and other requirements, if any, that would be applied to and enforced against a school that is operated by a school district. A municipality or county shall not enforce, or attempt to enforce, any ordinance, procedure or process against a charter school that cannot be legally enforced against a school district.[119]

Additionally, the Texas Education Code provides that "[a]n open-enrollment charter school is part of the public school system of this state."[120] The Delaware Education Code states that a "charter school shall be considered a public school for *all* purposes."[121]

Significantly, two recent state court opinions defined open-enrollment charter schools as "governmental units" for TCA purposes. In *LTTS Charter School, Inc. v. C2 Construction, Inc*., the Texas Supreme Court answered whether an open-enrollment charter school was a "governmental unit" as defined in the Tort Claims Act.[122] The court concluded that open-enrollment charter schools are "governmental units," reasoning that:

> Put simply, open-enrollment charter schools wield many of the same powers as traditional public schools. They have statutory entitlements to state funding and to the same services that school districts receive; they are generally subject to "state laws and rules governing public schools"; and they are subject to the "specifically provided" provisions of and rules adopted under the Education Code. Many specific provisions applicable to the educational programs of traditional public schools also apply to open-enrollment charter schools, including provisions relating to "the Public Education Information Management System," reading instruments and instruction, high school graduation, special education, bilingual education, prekindergarten programs, health and safety, and "public school accountability."
>
> . . . Likewise, for purposes of the Government Code's and Local Government Code's regulation of government records, "an

117. *See* NAT'L CTR. FOR EDUC. STATISTICS, *supra* note 11.

118. *See* ARIZ. REV. STAT. ANN. § 15-189.01 (2019); *see also* UTAH CODE ANN. § 53E-3-710 (West 2019).

119. *See* ARIZ. REV. STAT. ANN. § 15-189.01 (2019).

120. TEX. EDUC. CODE ANN. § 12.105 (West 2019).

121. DEL. CODE ANN. tit. 14, § 504(c) (2019) (emphasis added).

122. LTTS Charter Sch., Inc. v. C2 Constr., Inc., 342 S.W.3d 73 (Tex. 2011).

> open-enrollment charter school is considered to be a local government" and its records "are government records for all purposes under state law." And lastly . . . an open-enrollment charter school is considered to be: (1) a "governmental entity" for purposes of Government Code and Local Government Code provisions relating to property held in trust and competitive bidding; (2) a "political subdivision" for purposes of Government Code provisions on procurement of professional services; and (3) a "local government" for purposes of Government Code provisions on authorized investments.[123]

Similarly, in 2017, the New Mexico Court of Appeals held that charter schools are protected under New Mexico's Tort Claims Act.[124] In *Kreutzer v. Aldo Leopold High School*, a student sued a charter school after she was injured on the school's premises.[125] The student claimed that the charter school was "not entitled to TCA immunity because a privately operated charter school is neither a governmental entity nor a public employee as defined in the TCA."[126] The *Kreutzer* court ultimately concluded that the charter school was protected by the TCA, reasoning that:

> [A] "charter school" is a "public school" that operates as part of a "political subdivision[ ] of the state" and, as such, is a "governmental entity" . . . . A charter school also falls within the TCA's definition of "governmental entity" as including state "instrumentalities" and "institutions." Numerous statutory provisions, including many not cited here, reflect the interrelationship between charter schools and public schools, school boards, and school districts, and the Legislature's intent to treat charter schools as no less governmental entities than are public schools under New Mexico law.[127]

The specific authorizing language in charter school statutes and state court decisions such as *LTTS Charter* and *Kreutzer* illustrate how factor four may weigh in favor of classifying charter schools as governmental units for bankruptcy eligibility purposes. In states that clearly provide that public charter schools are part of the public school system, by way of statute or case law, a bankruptcy court might find that the fourth factor is satisfied. However, several states do not expressly state that public charter schools are part of the public education system. Therefore, an evaluation of this factor will also be highly state-dependent.

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123. *Id.* at 77–78 (footnotes omitted) (quoting TEX. EDUC. CODE ANN. §§ 12.103(a), (b), 12.104, 12.1052, 12.1053 (West 2011)).

124. *See* Kreutzer v. Aldo Leopold High Sch., 409 P.3d 930 (N.M. Ct. App. 2017).

125. *See id.*

126. *See id.* at 937.

127. *Id.* at 939 (second alteration in original) (citation omitted).

III. LOOKING AHEAD

Given the drastic expansion of public charter schools in the United States and corresponding influx of financial capital, charter schools pose a realistic bankruptcy risk. Although the handful of charter bankruptcies to date have filed under Chapters 11 or 7 without being challenged on the basis of the "governmental unit" exception, it is possible that such a challenge will come up in the future. If a creditor successfully argues that a public charter school is a "governmental unit" for Chapters 11 or 7 eligibility purposes, that can have a significant impact on the charter school's eligibility for *any* form of bankruptcy relief. If a charter is deemed to be a governmental unit, then the charter school will have no other option than to file under the municipal provisions of Chapter 9. As briefly discussed above, Chapter 9 eligibility comes with its own strict restrictions, thereby possibly rendering a charter school bankruptcy remote. This is because Chapter 9 is only available to governmental units that are also a municipality, and requires specific State authorization which is often difficult, if not statutorily impossible, to obtain.

Additionally, charter networks that operate in several states should carefully consider their bankruptcy options. As illustrated in this Note, determining whether a charter school is a governmental unit will drastically vary by state. However, because bankruptcy is undertaken under the auspices of the federal government, it may be difficult to resolve a situation in which a charter school is treated as a governmental unit in one state but not another.

Looking ahead, it is important for charter authorizers, charter investors, charter school operators, and charter creditors to understand the potential bankruptcy options associated with charter schools.