By Esther E. Tryban Telser

Governmental Entities: The Disenfranchised Creditors

Here's a question: The reason a governmental entity that holds the majority of debt of a reorganizing corporate debtor rarely sits on the unsecured creditors' committee of the debtor is:

A. Debtors don't accurately report debt owed to governmental entities when they file their lists of top 20 creditors.

[No. Debtors and their counsel are reasonably forthcoming in reporting debt owed to governmental entities, especially if those entities have been diligent in pursuing the debtor for payment.]

B. Governmental entities have no interest in sitting on creditors' committees.

[No. Governmental entities frequently request to serve on the committees of debtors whose reorganization is important to the entity.]

C. Governmental entities and the attorneys who represent them are just too disorganized, inefficient and unable to make decisions to be effective committee members.

[No, largely because there have not been enough cases in which governmental entities have been appointed to committees to make this determination. In any case, this is still a pretty harsh and unsubstantiated choice, and hopefully, if this answer was your choice, this article will reform your view.]

D. The Bankruptcy Code discourages appointment of governmental entities to creditors' committees.

[Yes. Sadly, this is true even though governmental entities are permitted to vote on and sometimes obtain denial of confirmation of plans lovingly crafted by dedicated committees. The well-meaning committee simply may inadvertently fail to realize that their plan does not address the needs of the excluded governmental entity. This failure to recognize that entity's interests may lead to opposition of the plan. Unfortunately, this opposition could lead to the need for extensive reformulation of the plan or, potentially, its confirmation failing due to lack of time for such reformulation if the court is pressed with urgency by a secured creditor.]

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The Code Provisions

Under most sections of the Bankruptcy Code, governmental entities are treated as any other creditor, with a glaring exception being the seeming intent of Congress to bar its kin from serving on unsecured creditors' committees. 11 U.S.C. § 1102(b)(1) provides:

> A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the *persons*, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee....

"Person" as defined in 11 U.S.C. § 101(41) includes "individual, partnership and corporation but does not include governmental unit." Those specifically excluded from personhood in 11 U.S.C. § 101(41) are enumerated in 11 U.S.C. § 101(27):

> The term "governmental unit" means United States; State; Commonwealth District; Territory; municipality; foreign state; department, agency or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government.

While the "shall ordinarily" language of § 1102(b)(1) of the Bankruptcy Code mixes the mandatory and permissive, most U.S. Trustees use these provisions to automatically and summarily exclude governmental entities from consideration as creditors' committee members, even if such an entity holds one of the seven largest claims against a debtor. In the rare instances where governmental entities overcome the hurdle of the U.S. Trustee's refusal to accord committee membership, it is usually by persuading the members of the committees themselves to invite the governmental entity to join the group as an *ex officio* member, which enables the governmental entity to participate but have nonvoting status and a lack of ability to chair subcommittees of the group.[1] Thus, governmental entities are told that they have no value to a committee absent the conference of value by true committee members, and even then, such entities are beneficial

1 The author must take this opportunity to applaud the U.S. Trustee for the Northern District of Illinois, who has shown exemplary progressive thinking by appointing governmental entities as full committee members when certain situations exist.

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to the committee only by their investment of resources without receiving the reciprocal meaningful participation in the voting or management of the committee.

The Committee's Role

The work of a creditors' committee is focused on building a consensus among creditors to formulate a reorganization plan for the debtor that permits the debtor to emerge from bankruptcy as a financially viable entity and provides sufficient compensation to creditors holding varied classes of debt to secure sufficient votes to confirm the proposed reorganization plan. With governmental entities performing the role of consensus-builders to achieve results beneficial to the majority through the best use of scarce resources on a daily—if not hourly—basis, debtors, creditors, U.S. Trustees and bankruptcy court judges should recognize the special skill set that governmental entities have that can be utilized in the work of creditors' committees. It would be in the best interests of these groups to join with the efforts of governmental entities to seek amendment of the Code to provide for full committee membership of governmental entities and, until then, to actively encourage U.S. Trustees to include governmental entities in their selection of committee members.

Congress intended the creditors' committee to be the primary body that negotiates with the debtor in possession (DIP) in its efforts to formulate a reorganization plan. Congress also tasked the creditors' committee with providing supervision of the DIP and with protecting the interests of unsecured creditors.[2] Initially, members of the creditors' committee were appointed by the bankruptcy court.[3] The bankruptcy judges, U.S. Trustees and Family Farmer Bankruptcy Act of 1986[4] transferred the duty of appointing members of the creditors' committee to the U.S. Trustee.[5] This change coincided with the effort by Congress to transfer administrative duties of the bankruptcy judge to the expanded U.S. Trustee system, which had existed only as a pilot program in some states prior to the 1986 Act.

Misconceptions and How Change Would Improve Confirmation Efficiency

The benefits of membership on a creditors' committee are well known, as the committees have become true partners with the debtors to craft reorganization plans that are not only confirmable but truly re-engineer the debtors into rejuvenated and reconstituted performers. As governmental entities increasingly hold debt in forms other than taxes and penalties, it is time to amend the Code to formally grant them full participation in committees, free from the pre-emptory exclusion from service by U.S. Trustees' rigid interpretation of 11 U.S.C. § 1102(b)(2).

The current language of the Code perpetuates this discriminatory treatment of governmental entities without clear historical or factual basis. The limited legislative intent[6] and more pervasive anecdotal history merely evidences the vague fears of governmental entities (1) having "different agendas" than other creditors, (2) delaying the work of the committees through some inability to formulate a decision on any matter; and (3) being in possession of sufficient protection of their interests through the priority treatment accorded to the bulk of their claims. It is difficult to lend credence to any one of these excuses for the continued exclusion of today's consensus-driven, decisive and general unsecured claim-holding governmental entities.

> **Yes, the bankruptcy process has survived and...benefited from the addition of formerly excluded governmental entities to creditors' committees. It is time for committee membership to be expanded to make all governmental entities eligible for full committee membership.**

First, the sheer desire of governmental entities to have reorganized debtors within their jurisdictions operating as their financially healthy partners provides sufficient motivation for these entities to be fully engaged in the reorganization of debtors as those entities are already well-informed about the debtors' businesses and business environments and can be critical evaluators of information and future plans provided by the debtor. While there may still exist somewhere in America governmental entities that are slow to decide or act, survival in today's economic times demands quick decisions and actions by those who helm governmental entities. Those that cannot rise to the necessity of such quick decision-making would likely be eliminated early in the process, for example, by failing to timely respond to a trustee's invitation to join a committee. Thus, it is difficult to justify the exclusion of governmental entities due to their having different agendas from other creditors in a case, especially when evaluated against the increasingly frequent circumstance of hedge funds or other holders of debt recently acquired through claims-trading. The funds and traders routinely secure places on committees, while admittedly having agendas that frequently diverge completely from those of the other members. In contrast, governmental entities regularly evaluate the relative merits of conflicting priorities and are the most likely creditor to recognize and support the reorganization of a debtor to the detriment of the entity's own

2 H.R. Rep. No. 595, 95th Cong., 1st Sess. 401 (1977).

3 11 U.S.C. § 1102(a)(1) (1982). As soon as practicable after the order for relief under this chapter, the court shall appoint a committee of creditors. (Replaced by current 11 U.S.C. § 1102(a)(1) (1986).

4 Pub. L. No. 9954 (1986).

5 This applies in all states to which the U.S. Trustee system was expanded by the 1986 Act, except for Alabama and North Carolina, which use bankruptcy administrators.

6 "The exclusion of governmental entities is made explicit in order to avoid any confusion that may arise if, for example, a municipality is incorporated and thus is legally a corporation as well as a governmental unit." H.R. Rep. No. 595, 95th Cong., 1st Sess. 313 (1977).

pecuniary interest for the good of the community, the state or (gasp) even the nation.

Second, any committee can protect itself against slothful or indecisive members by passing bylaws that provide for the removal of nonperforming committee members. Counsel who routinely serve committees are creative and resourceful and would likely have no trouble drafting provisions to provide for "use-it-or-lose-it" committee membership. Further, the process is well established for any committee to request removal of any nonperforming committee member, first to the U.S. Trustee and, if not resolved to the committee's satisfaction, to the bankruptcy court. As for the fear that governmental entities are such hydra-headed monsters of divergent internal interests that conflicting priorities within them would preclude consensus on any vote, the reality is that every entity has an ultimate decision-maker. He or she is used to hearing differently focused pitches on prioritization of the entity's interests and daily makes prompt and well-reasoned decisions on which interest comes first in any conflict. In fact, this experience with resolving diverse interests is a strength. Governmental leaders and their staffs provide value to committees through this skill in viewing decisions from different viewpoints that other creditors' representatives with single interests may lack.

Third, governmental entities today hold claims against debtors that vary in basis as much as the claims held by other creditors in the same case. These governmental entities' claims can include those of lender (with the same helpful knowledge of a debtor's finances and business as possessed by other lenders who routinely are selected as committee members), landlord, trade creditor (for goods or services procured or construction projects), or judgment creditor on nonpriority unsecured debt (similar to other judgment creditors who may receive payment only if the debtor successfully reorganizes). Thus, the frequent cry that governmental entities are already accorded preferential treatment in bankruptcies because all of their debt receives priority treatment in the plan provisions for payment is baseless when the governmental entity holds the type of debt listed above. While the greatest debt owed to governmental entities is admittedly tax debt, not even all tax debt receives priority treatment under the Code, and such unpaid nonpriority unsecured tax debt is frequently a debtor's largest debt. However, the holder of that debt, which has the most to lose in the case and is the most motivated to help the debtor survive and pay, is excluded from committee participation.

Additionally, another frequent role of the governmental entity, that of regulator of the debtor, militates toward inclusion of the entity in the committee as an active participant from the early days of the case in formulating the emergence of a reorganized debtor, rather than having its first opportunity to opine on the debtor's reorganization months—and perhaps years—after work has begun on the plan by the committee. The most excruciating denials of confirmation occur when a plan has been hammered out over an extended time through the hard work of a committee only to be a nonstarter when met with the objection of a regulating governmental entity that was not invited to the reorganization formulation table.

The Bankruptcy Reform Act of 1994[7] revised the exclusion of governmental entities from membership on creditors' committees by adding a provision to 11 U.S.C. § 101(41) to permit entities such as the Federal Deposit Insurance Corp., Pension Benefit Guaranty Corp. (PBGC) and state employee-pension funds to serve as members of creditors' committees. The PBGC has proven to be a positive addition to the committees on which it has served, and its participation has assisted in getting viable reorganization plans formulated and confirmed.

Yes, the bankruptcy process has survived and, some would say, benefited from the addition of formerly excluded governmental entities to creditors' committees. It is time for committee membership to be expanded to make all governmental entities eligible for full committee membership. The financial interests of these entities cannot continue to suffer due to their exclusion from the important work done on reorganization plans by creditors' committees, and confirmation of these finely honed plans should not be delayed or denied because of the failure of debtors and creditors' committees to consider the interests of these types of creditors until after a plan has been proposed. The Bankruptcy Code, being based on fairness and equity, should be amended to offer full representation to governmental entities on creditors' committees so that their financial interests receive the same consideration as those of other creditors. abi

7 Pub. L. No. 103-394.