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Alert

Divided Ninth Circuit Directs Review of Lender's Appeal from Cramdown Order

July 24, 2015

A lender's appeal from an order confirming a Chapter 11 debtor's cramdown reorganization plan is not equitably moot when the lender "diligently sought a stay" and the court could grant effective relief, held the U.S. Court of Appeals for the Ninth Circuit on July 1, 2015. *In re Transwest Resort Properties, Inc.*, 2015 WL 3972917, at *1 (9th Cir. July 1, 2015) (2-1). Review of the lender's appeal would not unfairly affect "third parties or entirely unravel the plan," reasoned the court when reversing the district court's dismissal and remanding to the district court for disposition of the merits.

The court applied four established criteria to find that the lender's appeal was not equitably moot: (1) whether the appellant sought a stay pending appeal; (2) "whether substantial consummation of the plan occurred"; (3) whether the relief sought would affect "third parties not before the court"; and (4) whether the relief sought would entirely unravel the plan. *Id.* at *3. The case ostensibly deals with the standard of appellate review for the judicially created doctrine of "equitable mootness," which allows an appellate court "not to reach the merits of a bankruptcy appeal." *Id*. But, as discussed in this *Alert*, the merit of the lender's appeal from a questionable reorganization plan confirmation order undoubtedly influenced the Ninth Circuit's holding.

Relevance

The equitable mootness doctrine may effectively prevent an objecting party from getting appellate review of a Chapter 11 plan confirmation order. For that reason, "[c]ourts must be cautious in applying equitable mootness when a party has been diligent about seeking a stay," noted the Ninth Circuit. *Id*. at *4.

The Third, Fifth, Seventh and Eleventh Circuits also limit the equitable mootness doctrine. In fact, the Seventh Circuit "banish[ed] 'equitable mootness' from the (local) lexicon." *In re UNR Indus.*, 20 F.3d 766, 769 (7th Cir. 1994). As the Seventh Circuit stressed in *UNR*, the threshold issue before the appellate court on an appeal from a confirmation order should simply be "whether it is prudent to upset [a] plan of reorganization … ." *Id. See In re One2One Communications, LLC*, 2015 WL4430302, at *16 (3d Cir. July 21, 2015) (reversing district court's dismissal of appeal from plan confirmation order and remanding for consideration of merits) (Krause, J., concurring) ("… [E]quitable mootness merely serves as part of a blueprint for implementing a questionable [reorganization] plan that favors certain creditors over others without oversight by Article III judges … We must consider whether to end or endure the mischief of equitable mootness.").

Facts
The five debtors filed a joint reorganization plan funded by an investment of $30 million from an investor ("Investor"). Investor would become the new sole owner of the debtors' hotels and eliminate the original equity interest in the hotels. The debtors' plan proposed to reinstate the debtors' $267-million "mortgage loan" from the objecting lender with a modified repayment schedule and a balloon payment after 21 years. The plan also included a "due-on-sale" clause requiring the reorganized debtors to pay the lender the entire remainder of the mortgage loan balance immediately upon sale or refinancing of the hotels within 21 years of the loan, but not between years five and 15 of the loan. The lender objected to: (1) the questionable modification of the due-on-sale clause; and (2) the bankruptcy court's application of the "cramdown" requirements of Bankruptcy Code Section 1129(b) (no impaired class of creditors had accepted plan, violating requirement of Section 1129(a)(10), giving the lender a veto of the plan). *Id.* The bankruptcy court confirmed the plan over both of the lender's objections.

The lender appealed from the confirmation order and moved to stay the consummation of the plan. Both the bankruptcy and district courts denied the motion, and the lender appealed to the Ninth Circuit.

When to Apply Equitable Mootness
The Ninth Circuit stressed its established reluctance to find an appeal equitably moot when a party has diligently sought a stay. Here, within four days of confirmation, the lender appealed and requested a stay. When the bankruptcy court denied the stay, the lender promptly moved in the district court, which also denied a stay. According to the Ninth Circuit, the lender was thus diligent in preserving its rights. *Id.* at *4.

Standard for Equitable Mootness
The parties had implemented the reorganization plan, rendering it "substantially consummated" when it reached the Ninth Circuit, a fact unfavorable to the lender. *Id.* at *3. It did not dispute this fact, for the Investor had assumed control over the debtors' hotels. *Id.* at *4. The court held, however, that "substantial consummation" of the plan had not created a presumption of mootness. *Id.* at *5. Instead, the court focused on whether equitable relief was available. The court also shifted the burden to the debtors and the Investor to prove that no equitable relief was available.

The court held that any third-party reliance on consummation of the plan was not persuasive here. Instead, it asked whether the proposed plan modifications would be inequitable. Modifying the due-on-sale clause would only affect the Investor, who was "not the type of innocent third party" that should be protected. *Id.* at *5. Based on the Investor's participation in the bankruptcy case and its role in the loan negotiations, it "became involved" as an investor and owner of the properties. *Id.* Furthermore, it was a "sophisticated investor," and the "appellate consequences [were] foreseeable." *Id.* at *6. There was thus no undue burden on an innocent third party, for the Investor had a more direct interest than an innocent third party and should have known appellate review was possible. Finally, because the proposed plan modifications — distribution of money from the Investor to the lender or reinstatement of the lender's liens — would "alter only the relationship" between those parties, there was hardly an undue burden on an innocent third party. *Id.*

Finally, reasoned the court, the bankruptcy court could fashion equitable relief without completely unraveling the plan. Even the availability of partial relief would render the appeal not moot. *Id.* Eliminating the due-on-sale clause would give the lender relief, but partial remedies for the lender also existed, such as limiting the window during which the due-on-sale clause would not apply or giving the

lender some percentage of the difference between the remainder of the total loan amount and the loan's present value during the window. *Id.* at *6-7. In fact, noted the Ninth Circuit, the Investor and the debtors had already argued against the plan's unraveling in the lower courts when they stated that the due-on-sale clause presented no immediate harm to the lender and any potential future sale was speculative. Finally, said the court, even though the lender's veto power over the plan could not be reinstated, the bankruptcy court could still impose monetary relief in the form of a buyout of the veto's value to the lender. *Id.* at *7-8. This would not unravel the plan and would provide at least some relief to the lender. *Id.* at *8.

Dissent

In the dissent's view, any relief would be "grossly inequitable" to the Investor and "jeopardize the reorganization." *Id.* Appellate review, it argued, would discourage potential investors from relying on bankruptcy court confirmation orders or buying struggling properties, which would impede the Chapter 11 reorganization process. *Id.*

Comments

Most appellate courts agree with the Ninth Circuit's limiting of the equitable mootness doctrine. *See, e.g.*, *In re Semcrude, L.P.*, 728 F.3d 314, 321, 326-327 (3d Cir. 2013) ("[Dismissing an appeal] should be the rare exception and not the rule[.]"); *In re Pacific Lumber Co.*, 584 F.3d 229, 240 (5th Cir. 2009) ("'Equitable' mootness should be applied with a 'scalpel rather than an axe."); *In re UNR Indus.*, 20 F.3d at 769 ("We ask not whether this case is moot, 'equitably' or otherwise, but whether it is prudent to upset the plan of reorganization at this late date."). Most appellate courts place the burden of proving equitable mootness on the moving party. *See, e.g.*, *In re Semcrude*, 728 F.3d at 322 ("placing the burden on the party seeking dismissal" to show equitable mootness)*; In re One2One Communications*, 2015 WL4430302, at *5 ("… [I]t was the Debtor's burden, as the party seeking dismissal, to demonstrate that the prudential factors weighed in its favor.").

Circuits only slightly disagree as to the wording of the applicable standard to determine equitable mootness. *See, e.g.*, *In re Semcrude*, 728 F.3d at 321 (applying a two-step test: (1) whether the confirmed plan has been substantially consummated; and (2) whether granting relief would (a) fatally scramble the plan and/or (b) significantly harm third parties who justifiably relied on plan confirmation); *In re Age Refining, Inc.*, 537 Fed. Appx. 393, 397 (5th Cir. 2013) (applying a three-part test: (1) whether a stay was obtained; (2) if not, whether the plan was substantially consummated; and (3) whether the relief requested would affect either the rights of parties not before the court or the success of the plan, citing *In re Clinton Manges*, 29 F. 3d 1034, 1039 (5th Cir. 1994)); *In re Sagamore*, 2015 WL 4170215 (11th Cir. 2015) ("Equitable mootness applies when 'effective relief is no longer available,' quoting *In re Club Assocs.*, 956 F.2d 1065, 1069 (11th Cir. 1992)). Only the Second Circuit seems more inclined to avoid a review of plan confirmation orders. *In re Charter Communications, Inc.*, 691 F.3d 476, 481-83 (2d Cir. 2012) (declining to review merits of appeal; when plan substantially consummated, an objection is presumed moot and objecting party must: (1) overcome presumption by meeting a five-step test; *and* (2) prove lower court abused its discretion).[1]

[1] The five-step test, known as the *Chateaugay* test, is the following:

1) The court can still order some effective relief;
2) Relief "will not affect the reemergence of the debtor as a revitalized corporate entity";
3) Relief will not "unravel intricate transactions so as to knock the props out from under the authorization for every transaction that has occurred, nor can it create an unmanageable, uncontrollable situation for bankruptcy court";

The Ninth Circuit's narrow view of the equitable mootness doctrine is fair, reasonable and consistent with the approaches taken by the Third, Fifth, Seventh and Eleventh Circuits. It places less emphasis on substantial consummation and focuses more on what remedies are available to the objecting party. As one court of appeals judge just noted, the equitable mootness doctrine has had a "deleterious effect on our [bankruptcy] system … . By excising appellate review, equitable mootness not only tends to insulate errors by bankruptcy judges or district courts, but also stunts the development of uniformity in the law of bankruptcy." *In re One2One Communications*, 2015 WL4430302, at *15 (Krause, J., concurring).

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4) Adversely affected parties have notice of appeal and the opportunity to participate; and
5) Appellant diligently pursued all available remedies to obtain a stay of execution of the objectionable order if failure to do so creates a situation making it inequitable to reverse the lower courts.

In re Chateaugay Corp., 10 F.3d 944, 952-53 (2d Cir. 1993).