LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 32, Number 11 • September 2015

Time to Revisit Equitable Mootness

By Michael L. Cook

Respected appellate judges have condemned the judicially created doctrine of "equitable mootness" for at least the past 20 years. That doctrine allows an appellate court to avoid reaching the merits of an appeal from a Chapter 11 plan confirmation order. *See, e.g., In re Nordhoff Invs. v. Zenith Elecs. Corp.*, 258 F. 3d 180,185 (3d Cir. 2001) ("doctrine prevents … court from unscrambling complex bankruptcy reorganization … [plans] ."). In 1994, Judge Frank Easterbrook, speaking for the U.S. Court of Appeals for the Seventh Circuit, however, "banish[ed] 'equitable mootness' from the local "lexicon." *In re UNR Indus.*, 20 F. 3d 766, 769 (7th Cir. 1994). Most recently, Judge Cheryl Ann Krause of the U.S. Court of Appeals for the Third Circuit, in a concurring opinion on July 21, 2015, urged the court to "consider eliminating, or at the very least reforming equitable mootness." *In re One2One Communications, LLC*, 2015 WL 4430302, at *7 (3d Cir. July 21, 2015). Two recent decisions from the U.S. Courts of Appeal for the Third and Ninth Circuits confirm why Judge Krause is right.

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 a split panel of 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. Similarly, in *One2One Communications* , because the "[confirmed] Plan did not involve the issuance of any publicly traded scurities, bonds, or other circumstances that would make it difficult to retract the plan, and because "of the limited evidence of potential third-party injury," the Third Circuit reversed the district court's dismissal of the appeal on equitable mootness grounds, requiring the lower court to hear the merits. 2015 WL 4430302, at *6.

Applicable Standards

The Ninth Circuit in *Transwest* 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. 2015 WL 3972917, at *3. *See also In re Sagamore*, 2015 WL 4170215 11th Cir. 2015) ("Equitable

Michael L. Cook, a member of this Newsletter's Board of Editors, is a partner at Schulte Roth & Zabel LLP in New York.

mootness applies when 'effective relief is no longer available.'"). The Third Circuit in *One2One* essentially agreed with these "'prudential' factors," but also considered "the public policy of affording finality to bankruptcy judgments." 2015 WL 4430302, at *3. Both cases ostensibly deal with the standard of appellate review, but, as shown below, the merits of the creditors' appeals from questionable reorganization plan confirmation orders undoubtedly influenced their holdings.

Relevance

The equitable mootness doctrine effectively prevents an objecting party from getting appellate review of a Chapter 11 plan confirmation order. For that reason, "[c]ourts [are supposed to] 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, Seventh, and the U.S. Courts of Appeal for the Fifth and Eleventh Circuits agree. More significant, Judge Krause, in *One2One Communications*, 2015 WL4430302, at *16, stressed the real problem with the doctrine: " … [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."

Merits of the Appeals

The debtors in *Transwest* and *One2One* had simple debt structures. In *Transwest*, the "Investor"-funded plan had no impaired creditors accepting it, contrary to Bankruptcy Code § 1129(a)(10) (requiring "at least one class of [impaired] claims"), and crammed down a secured lender's $267 million "mortgage loan with a balloon payment after 21 years," imposing on the lender a limited "due-on-sale" clause over its objection. Similarly, in *One2One*, the largest unsecured creditor objected to a plan that gave creditors a less than 10% distribution payable over seven years, waiving preference claims against other creditors and allowing equity to retain property, in violation of the absolute priority rule (Code § 1129(b)). The creditors objected and unsuccessfully moved to stay consummation of the plans in both cases.

Diligence

The Ninth Circuit stressed in *Transwest* its established reluctance to find an appeal equitably moot when a party has diligently sought a stay. 2015 WL 3972917, at *4. The Third Circuit agreed in *One2One* , 2015 WL 4430302, at *4, *1. Both appellants had promptly appealed and requested a stay, showing diligence in preserving their rights.

Substantial Consummation

The debtors in *Transwest* and *One2One* had implemented their reorganization plans, purportedly rendering them "substantially consummated" when the appeals reached the circuit courts, a supposedly unfavorable fact. Finding "substantial consummation" of the plan had not created a presumption of mootness. However, the Ninth Circuit in *Transwest* focused on whether equitable relief was available. 2015 WL 3972917 at *5. The court also shifted the burden to the debtors and the Investor to prove that no equitable relief was available. Similarly, the Third Circuit, in *One2One* , found that "this case did not involve a sufficiently complex … reorganization such that dimissal on the basis of equitable mootness would be appropriate [*i.e.*, "no publicly traded securities, bonds that would make it difficult to retract the Plan"]." 2015 WL 4430302, at *5 -*6.

Third-Party Reliance

Both courts held that any third-party reliance on consummation of the plan was not persuasive. Instead, they asked whether the proposed plan modifications would be inequitable. Modifying the due-on-sale clause in *Transwest* would only affect the Investor, who was "not the type of innocent third party" that should be protected. 2015 WL 3972917 at *5. He had participated in the bankruptcy case; negotiated a loan and "became involved" as owner of the properties. *Id*. Furthermore, he 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. *Id*. 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*. Similarly, the Third Circuit in *One2One* found third-party reliance to be "minimal," and that the "ordinary course" sponsor "investment … , [creditor] distributions, … hiring of new employees and entering into … agreements … are likely to transpire in almost every … reorganization where the appealing party is unsuccessful in obtaining … a stay [pending appeal]". 2015 WL 4430302, at *6.

Available Relief

Finally, reasoned the Ninth Circuit in *Transwest*, the bankruptcy court could fashion equitable relief without completely unraveling the plan. Even the availability of partial relief was enough to keep the appeal alive. 2015 WL 3972917, at *6. Eliminating the due-on-sale clause would give the lender relief, and partial remedies for the lender also existed. *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 because any potential future sale was speculative. Finally, said the court, the bankruptcy court could still impose some form of monetary relief for the lender without unravelling the plan. *Id*. at *7-*8.

Equitable Mootness As a Weapon

Judge Krause's comprehensive concurring opinion in *One2One* details the legal and practical flaws in what she calls the "legally ungrounded and practically unadministrable 'judge-made abstention doctrine' of equitable mootness." 2015 WL 4430302, at *7. Essentially, she shows, after reviewing the Third Circuit's "dismal experience with the doctrine," that it has permitted "the abdication of jurisdiction." *Id*. at *8, *17. In her view, there is no "constitutional or statutory anchor for declining to exercise jurisdiction over bankruptcy appeals dubbed 'equitably moot.'" *Id*. Because a court's declining to hear the merits of a plan confirmation order appeal does not lead to review in another forum, "relinquishing jurisdiction is not abstention; it's abdication." *Id* . at *9. Moreover, "the Bankruptcy Code and related jurisdictional statutes provide no support for equitable mootness and actually undermine it." *Id*. at *10. As a matter of constitutional law, "equitable mootness not only allows bankruptcy court decisions to avoid review, but also enables bankruptcy judges to insulate their decisions from review at their discretion … . [O]pportunistic plan proponents can (and … regularly do) use this to their advantage." *Id*. at *14. Regardless of whether the Third Circuit "[revisits] equitable mootness," Judge Krause recommended "at least four reforms" to "consider if [the court] opted to maintain [the] abstention doctrine":

" … place greater weight on an appellant's attempts to obtain a stay";

"clarify what constitutes 'significant … harm' to 'third parties who have' justifiably relied on plan confirmation'… . And we should be even less solicitous of parties who act opportunistically or advocate unlawful plan provisions during confirmation.";

"reconsider our standard of review … of equitable mootness" dismissals — from "abuse of discretion" to "plenary"; and

"incorporate 'a quick look at the merits of [an] appellant's challenge' to determine if it is 'legally meritorious or equitably compelling'," particularly when the "Code's cram down provisions" are at stake or when "conflicts of interest or preferential treatment" are raised.

Id. at *20-22.

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]

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).

—❖—

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";
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.

Schulte Roth&Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London