EQUITABLE MOOTNESS – RECENT DEVELOPMENTS

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Equitable mootness is a longstanding judge-made doctrine recognized in every circuit except the federal circuit (which does not hear bankruptcy appeals). Bankruptcy appeals may also be held statutorily moot when 11 U.S.C. § 363(m) applies to the appealed order. *E.g. In re Ondova Limited Co*., 620 Fed.Appx. 290 (5th Cir. 2015). In rare circumstances, an appeal also might be constitutionally moot because the court lacks jurisdiction to consider the issues in the absence of a case or controversy. *In re Castaic Partners II, LLC*, 823 F.3d 966 (9th Cir. 2016) (underlying bankruptcy case dismissed while appeal was pending); *In re Anderson*, 604 Fed.Appx. 735 (10th Cir. 2015) (appeal of abandonment order dismissed after foreclosure removed jurisdiction over property).

The equitable mootness doctrine usually arises in the context of a plan confirmation order appeal when the plan has been consummated during the appeal. If an appeal is equitably moot, it will be dismissed. Courts formulate the rule in different ways, but in general, a matter is equitably moot when it is no longer possible (or equitable) to grant relief without causing harm to others, usually because their position has sufficiently changed in reliance on the order. The factors cited in most cases include a variation of those in the seminal *Continental* decision:

> (1) whether the reorganization plan has been substantially consummated,
> (2) whether a stay has been obtained,
> (3) whether the relief requested would affect the rights of parties not before the court,
> (4) whether the relief requested would affect the success of the plan, and
> (5) the public policy of affording finality to bankruptcy judgments.

In re Continental Airlines, 91 F.3d 553, 560 (3d Cir. 1996). It is common for courts to combine the third and fourth factors into "whether the bankruptcy court can fashion effective and equitable relief without completely knocking the prop out from under the plan and thereby creating an uncontrollable situation for the bankruptcy court." *E.g. In re Nica Holdings, Inc.*, 810 F.3d 781, 787 (11th Cir. 2015); *In re Thorpe Insulation Co.*, 677 F.3d 869, 881 (9th Cir. 2012), *citing In re Roberts Farms*, 652 F.2d 793, 798 (9th Cir. 1981).

In the last few years, there have been extensive analyses of equitable mootness in Third Circuit and Ninth Circuit opinions, limiting the scope of the equitable mootness doctrine, and in some instances also attempting to confirm its very existence and rationale. A Sixth Circuit case applied the equitable mootness doctrine in the context of a Chapter 9 plan.

Third Circuit

In 2015, two Third Circuit cases included lengthy discussions of the equitable mootness doctrine. In *In re One2One Communications, LLC*, 805 F.3d 428 (3d Cir. 2015), a Third Circuit panel held that an order confirming a Chapter 11 plan was not equitably moot because the debtor/appellee failed to carry its burden of proving third party reliance on plan confirmation. The court explained that the case did not concern a complex reorganization, with few creditors, only a $200,000 investment, and no new financing, mergers, or significant transactions. It held that the test is whether the plan could be unraveled without great difficulty or inequity. There was no such evidence in the *One2One* case, and minimal evidence of third party reliance that could be characterized as a significant injury.

Judge Krause wrote a lengthy concurrence, arguing that the Third Circuit's adoption of the equitable mootness doctrine in *Continental Airlines* should be reversed because it lacks a constitutional or statutory basis, or should be narrowed to inapplicability in modest, garden variety bankruptcy cases. The concurrence contended that parties are entitled to adjudication by an Article III court, which they do not receive if appellate courts decline to decide bankruptcy appeals. And it said that equitable mootness promotes uncertainty and delay rather than finality, noting that the district court's finding of equitable mootness in that case was reversed two years later in the Third Circuit's decision.

A month after the *One2One* decision, a different panel of the Third Circuit issued *In re Tribune Media Co*., 799 F.3d 272 (3d Cir. 2015), which held that appeals of a plan confirmation order were equitably moot in part. This decision likewise included a lengthy concurrence, this time by Judge Ambro.

The opinion held that because equitable mootness is applied with a scalpel rather than an axe, the court should not decline review simply because full relief is impossible if it can fashion some practical relief, in that case by enforcing a subordination agreement by terminating further payments to an allegedly junior priority class after confirmation and substantial consummation. But it held that severing a litigation settlement from the plan was equitably moot when that settlement was the most important aspect of the plan, and reversing it would drastically diminish the value of new equity's investment in reliance on the settlement. The appellant should have diligently pursued a stay pending appeal by either paying or challenging the amount of a supersedeas bond.

In the concurrence, Judge Ambro explained that because bankruptcy courts are courts of equity, they may decline to decide a case on the merits where relief would dismantle a consummated plan or disturb third parties' reasonable reliance on plan finality. He analogized the approach to Rule 65 injunction balancing of harms.

The concurrence argued that an equitable mootness determination by the Article III appellate court does not infringe constitutional rights, and noted that as a practical matter, abolishing the doctrine would thwart complex reorganizations from being consummated until all appeals are decided. It said that delay in reorganizations is costly, leading to difficulty attracting investors, employees and possibly customers, and giving litigious creditors hold-up settlement leverage.

The *Tribune Media* concurrence reaffirmed the *Continental* position that singled out investors as the "particular" beneficiaries of equitable mootness. Although other parties such as lenders, customers, suppliers and other creditors may also "claim protection in the form of equitable mootness, they may not 'merit the same "outside investor" status as' those who make equity investments in a reorganized entity." Still, the concurrence reiterated that equitable mootness is a rare exception to deciding appeals on the merits, and is only in play when modifying a court order approving a consummated plan would do significant harm.

<u>Ninth Circuit</u>

Despite many reported and unpublished cases applying the equitable mootness doctrine to protect third parties relying on consummated plans, the Ninth Circuit held that an outside equity investor was not sufficiently "innocent" to merit protection in *In re Transwest Resort Props. Inc*., 791 F.3d 1140 (9th Cir. 2015). The opinion did not define "innocent" nor cite any authority giving meaning to the innocence requirement. It held that the investor's "involvement in the reorganization process," by helping to "craft a reorganization plan that 'press[es] the limits' of the bankruptcy laws," "means that it is not the type of innocent third party that the third prong of the equitable mootness test is designed to protect." However, the opinion did not indicate specifically what was wrong with an investor helping to craft the plan before making its investment, or its lawyer appearing at a confirmation hearing.

As explained by the dissent, the *Transwest* majority failed to note that the circuit court authority it cited bearing on the requisite "innocence" of the third party referred to a third party competitor who was responsible for the deficiencies in the plan. *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

In most cases emphasizing the importance of protecting outside investors' reliance interests, the investor had participated in crafting the plan of reorganization by insisting on the very terms that were the subject of the appeal, and even participated at some level of the appeal. In *In re Manges*, 29 F.3d 1034 (5th Cir. 1994), the "investor" who funded the payment of "millions of dollars in administrative and priority claims . . . to claimants who are not parties to this appeal" was actually the plan proponent and secured creditor in the case.

With respect to the possibility of relief without knocking the props out from under the plan, *Transwest* authorized appellate courts to speculate about possible forms of relief other than what the appellant sought. It held that this factor can be decided against equitable mootness if the appellant could be granted a "one day" extension of a plan deadline or awarded "one percent" of the discharged unsecured debt without undermining the "entire plan."

The opinion did not suggest either that the appellant had requested such relief or would be satisfied with it. The opinion offered no definition of the meaning of "effective," nor any authority that one dollar is more effective than nominal. The opinion did seem to recognize that this novel restatement of the factor effectively requires appellee to prove the negative, that "*any* relief would be inequitable." But it did not recognize that because that is probably never possible to prove, especially if "one dollar" of damages qualifies as "effective relief," it effectively eliminates this factor altogether, even though it has been a requirement since the earliest precedents.

Judge Milan Smith penned a strong dissent. He said that the majority's decision discourages potential investors from relying on the finality of confirmation orders or from investing in struggling properties until all litigation is concluded, which can take many years. This impedes the Bankruptcy Code's goal of maximizing debtors' estates and facilitating successful reorganizations:

> The rule adopted by the *Transwest* majority, and expanded here, ignores the realities of the marketplace, and creates strong incentives for investors to delay funding improvements until after the appeal is completed…decreasing the value of [the lender's] collateral and impeding, or terminating, the ability of the Debtors to generate cash flow and service their debt. Worse, the majority approach discourages third parties from agreeing to make these kinds of post-confirmation investments in the first instance…decreasing the value of debtors' estates *ex ante* and making it more difficult to facilitate workable reorganizations.

Transwest, 801 F.3d at 1175. The dissent also noted that there was no indication that the investor had any connection to the case until the debtors approached it to fund a plan they had already crafted. At that point, it was only natural that the investor would be involved in the bankruptcy proceedings, because its investment was the very reason the proposed reorganization was feasible.

The *Transwest* holding was adopted and expanded in *In re Sunnyslope Housing Ltd. Partnership*, 818 F.3d 937 (9th Cir. 2016), *en banc* argument under advisement. The panel again held that an investor that purchased the debtor's equity under a plan is not an "innocent" third party entitled to the protection of equitable mootness. In *Sunnyslope*, the investor had consummated a Tax Code § 1133 exchange and would suffer significant tax liabilities if plan confirmation were to be reversed, and did so only after district court affirmance on the appeal merits as well as stay denial. In effect, the opinion held that it is unreasonable to fund a plan whenever an appeal is taken, taking the Ninth Circuit out of step with equitable mootness precedent across circuits.

The *Sunnyslope* panel opinion also held that a plan confirmation order can be reversed in its entirety, despite the impact upon other creditors, because those creditors "made no additional investment" – just negotiated claim treatment. The majority said the creditors were not "unable to protect themselves," but their protection was through the confirmed plan providing for full payment and full compliance with their property use restrictions.

Finally, the panel held that a consummated plan with multiple implemented transactions and payments can be axed, instead of applying a scalpel to specific provisions, again conflicting with decisions across the circuits and previous Ninth Circuit authority.

The Ninth Circuit granted a motion for reconsideration *en banc*, which was argued on January 17, 2017.

<u>Sixth Circuit</u>

The Sixth Circuit applied the equitable mootness doctrine to dismiss an appeal in a Chapter 9 case in *In re City of Detroit*, 838 F.3d 792 (6th Cir. 2016). It held that the complex network of settlements and agreements with thousands of creditors memorialized and implemented in the confirmed plan would not be unscrambled at the request of pensioners resisting a reduction in their benefits.

The court distinguished the equitable mootness doctrine as not technically "mootness," but instead a prudential doctrine that protects need for finality in bankruptcy proceedings and allows third parties to rely on that finality by preventing an appellate court from reversing complex bankruptcy reorganizations when the appealing party should have acted before reorganization plan became extremely difficult to retract. It said that the court is concerned with protecting the good faith reliance interests created by implementation of bankruptcy plan from being undone afterwards. More akin to waiver or forfeiture, or perhaps estoppel, than to conventional mootness, equitable mootness is grounded in the notion that, with passage of time after a judgment in equity and implementation of that judgment, effective relief on appeal becomes impractical, imprudent, and therefore inequitable.

The court applied a three-part test: (1) whether a stay was obtained; (2) whether the bankruptcy plan has been substantially consummated; and (3) whether the relief requested would significantly and irrevocably disrupt implementation of plan or disproportionately harm the reliance interests of other parties not before the court. It held that failure to seek a stay is not necessarily fatal, but neither is merely seeking a stay alone sufficient to prevent dismissal of an appeal as equitably moot. The court pointed out that a stay not sought, and a stay sought and denied, lead equally to the implementation of plan of reorganization. It held that dismissal of a plan confirmation order appeal is not necessarily appropriate even after substantial consummation.

The court explained that the most important factor in deciding whether an appeal from a plan confirmation order is equitably moot is whether the relief requested would affect the rights of third parties or the overall success of the plan, which requires a case-by-case assessment of feasibility and effect of relief requested, and determination of whether it amounts to a piecemeal revision of plan or a wholesale rewriting. In the *Detroit* case, the pensioners' appeals were held equitably moot where numerous significant, even colossal, actions had been undertaken or completed, many irreversibly, in reliance on the plan. The relief that the pensioners requested on appeal would necessarily rescind the bargain that was at the heart of Detroit's negotiated plan and would adversely affect countless third parties, including the entire city population.

Equitable Mootness Hypothetical

Widgets, Inc. confirmed a Chapter 11 reorganization plan, under which Angel Investments LLC (owned by the husband of the equity owner) invested \$50,000 and made a secured loan of \$100,000 more on the condition that the company commit to compliance with the investor's business plan. This was sufficient to pay the administrative and priority creditors, and pay 15¢ on the dollar to the 25 trade creditors, pay the secured creditor over 5 years, and capitalize the company sufficiently that the bankruptcy court found the plan feasible and the secured creditor adequately protected. Widgets, Inc. declined to pursue a competitor's offer to buy the business that would have resulted in nearly-full payment of unsecured creditors and satisfied the unsecured creditor.

The secured creditor appealed, arguing that the plan was not feasible, and that by the time the case ends up in Chapter 7 after an inevitable default, the tooling and equipment that the competitor wants to buy will have depreciated and the receivables it wants to purchase will be uncollectable, and the secured creditor will get nothing. It claims that the investor's priming lien was illegal because it is not adequately protected. Its motion for a stay pending appeal to the bankruptcy court was summarily denied.

Two weeks after entry of the confirmation order, the investment funds were received and investor's security interest perfected, priming the secured creditor, and distributions were made. Widgets, Inc. filed a motion to dismiss the appeal on grounds of equitable mootness.