When it is Fair: Recent Circuit Court Decisions on Equitable Mootness

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Generally, once a plan of reorganization is confirmed and substantially consummated, an appellate court will not “unscramble the egg” and grant appellate relief if doing so would harm third parties that relied on the confirmation order. Almost 20 years ago, the Third Circuit Court of Appeals articulated the doctrine of equitable mootness to address this scenario. Equitable mootness is “a judge-made abstention doctrine that allows a court to avoid hearing the merits of a bankruptcy appeal of a confirmation order because implementing the requested relief would cause havoc.” Recently, the Third and Ninth Circuits helped clarify the application and scope of the equitable mootness doctrine and found that not all substantially consummated plans are protected by the equitable mootness doctrine.

The Third Circuit has two recent opinions concerning equitable mootness:

In In re One2One Communications, LLC, the debtor was sued by the appellant, which held the single largest claim against the debtor. After the debtor’s fourth bite at the confirmation apple and following a five-day confirmation hearing, the Bankruptcy Court, over the objection of the appellant, entered the confirmation order. Appellant appealed and moved for a stay pending appeal, which was denied. Without reaching the merits of the confirmation order, the District Court dismissed the appeal on the grounds of equitable mootness.

The Third Court outlined five previously established factors for determining whether an appeal is equitably moot:

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.

The debtor in One2One presented a fairly straightforward plan involving a $200,000 investment in the reorganized debtor; one secured creditor that held a blanket lien on the debtor’s assets for less than $100,000; 17 unsecured creditors, not including insiders; and no new financing, mergers or dissolutions of entities, issuance of stock or bonds, name change, change of business location, change in management or any other significant transactions.

Given the simple transaction contemplated under the plan, the Court recognized that there had been no evidence that the plan would be difficult to unravel, that third-party reliance on the plan was anything other than minimal or that any third party would be harmed by considering the appeal and unraveling the plan if warranted. Accordingly, the Third Circuit held that equitable mootness did not apply, and remanded the matter back to the District Court for consideration of the merits of the appeal.
Further, the Third Circuit cautioned that the equitable mootness doctrine must be narrowly construed and should apply only in complex bankruptcy cases where the appealing party should have acted (but did not) before the plan became difficult to retract.

In *In re Tribune Media Company Tribune*, two creditors appealed the order confirming the plan of the Tribune Company (of Chicago Tribune and Los Angeles Times fame). One creditor (Litigation Creditor) sought to undo the litigation settlement that was a crucial component of the consummated plan; the other creditor (Intercreditor Creditor) sought to enforce rights as between two creditor classes under the plan. The District Court dismissed both appeals as being equitably moot.

The Third Court consolidated the five-factor test it recognized in *One2One*, succinctly explaining that the analysis should revolve around:

1. whether a confirmed plan has been substantially consummated; and
2. if so, whether granting the relief requested in the appeal will fatally scramble the plan and/or significantly harm third parties who have justifiably relied on the plan’s confirmation.

In contrast to *One2One*, the *Tribune* plan was complex involving $7.5 billion, thousands of creditors and a global settlement of a multi-billion dollar leveraged buyout litigation. The plan had been substantially consummated (i.e., the first requirement was satisfied), and as a result, the Court’s analysis was limited to whether the relief sought would “fatally scramble the plan.”

As to the Litigation Creditor, the Court noted that the litigation settlement was “a central issue in the formulation of a plan of reorganization” such that granting the appeal would undermine the associated settlements and transactions, and would “recall the entire Plan for a redo.” Because of its detrimental impact to the plan and third parties, the Court relied on equitable mootness to sustain the dismissal of the Litigation Creditor’s appeal.

On the other hand, the Intercreditor Creditor’s appeal was not equitably moot because, even though the plan had been substantially consummated, the resolution a $30 million intercreditor dispute between two classes of the plan would not unravel the plan or unfairly treat other creditors; it would merely reallocate dollars from a group that had no legitimate expectation of payment to the rightful recipients. Thus, the Third Circuit remanded the Intercreditor Creditor’s appeal for further determination.

The Ninth Circuit recently opined on equitable mootness as well:

In *In re Transwest Resort Properties, Inc.*, the Ninth Circuit reversed the District Court and found that the plan at issue would not unravel nor would third parties be adversely affected if the appeal of the confirmation order were permitted to proceed. A key factor in the Court’s reasoning was that the objecting party had diligently (albeit unsuccessfully) sought a stay of the confirmation order in the Bankruptcy Court and District Court.

In *Transwest*, five related entities had acquired two hotels, the Westin Hilton Head Resort and Spa and the Westin La Paloma Resort and Country Club. They financed the acquisition with over $200 million of first lien debt and $21 million of mezzanine debt.

After default and bankruptcy, the debtors filed a joint plan of reorganization. The plan proposed to reinstate the first lien loan, but to restructure the payments as interest-only with a bullet after 21 years. The new terms also included a due-on-sale clause such that any sale or refinancing of the hotels would trigger an immediate obligation to pay the loan in full, provided that between years five and fifteen of the loan, the hotels could be sold or refinanced subject to the loan. A third party invested substantial amounts in connection with the plan.

The lender previously had made the 1111(b)(2) election to have its claim treated as fully secured, and thus objected to the plan on the grounds that the plan’s treatment of the due-on-sale clause effectively undid the election, which was made to protect the lender’s claim if the value of the collateral increased during the term of the loan and thereafter was sold or refinanced by the debtor. Additionally, the lender contended that the debtor did not meet a particular confirmation standard with respect to one of the five debtors under the joint plan.

The lender appealed the confirmation order and sought a stay pending appeal. Both the Bankruptcy Court and the District Court denied the stay and, the plan having been substantially consummated, the District Court dismissed the appeal as equitably moot.

The Ninth Circuit set out its four factor test for determining the applicability of equitable
mootness:

1. whether a stay was sought;
2. if so, whether substantial consummation has occurred;
3. the effect a remedy may have on third parties not before the court; and
4. whether effective and equitable relief can be fashioned without completely knocking the props out from under the plan.

There was no dispute as to the first two factors: the lender had actively pursued a stay, and the proponents has substantially consummated the plan. As to the third factor, the Court viewed the third party investor as an active participant in the negotiation of the plan and in the ensuing appellate battle. In other words, the investor was not an unsuspecting third party that detrimentally relied on the confirmed plan, and unwinding it would not significantly harm the investor. Thus, the third factor did not favor mootness.

Finally, the Court put the most weight on the fourth prong of the analysis – whether equitable relief could be fashioned without undoing the plan. Citing precedent, the Court noted that the availability of even partial relief for the appellant renders the equitable mootness doctrine inapplicable. Here, the Court believed that if the lender were successful on its appeal, the Bankruptcy Court could fashion at least partial relief for the lender, such as reducing the duration of the due-on-sale exception.

courts are urged to apply equitable mootness “with a scalpel rather than an axe” because it “is a narrow doctrine by which an appellate court deems it prudent for practical reasons to forbear deciding an appeal when to grant the relief requested will undermine the finality and reliability of consummated plans of reorganization.”

In sum, these Circuit Court decisions make clear that courts should not always rubber stamp plan confirmation orders in the name of equitable mootness. Instead, courts are urged to apply equitable mootness “with a scalpel rather than an axe” because it “is a narrow doctrine by which an appellate court deems it prudent for practical reasons to forbear deciding an appeal when to grant the relief requested will undermine the finality and reliability of consummated plans of reorganization.” Major players in a chapter 11 effort must take note that confirmation may be just the first step in a contested plan process. Equitable mootness may not prevent a disgruntled party from pursuing modification of even a substantially consummated plan.


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