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Equitable Mootness

Two Recent Third Circuit Decisions

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Equitable mootness is a judge-made remedy that is misnamed. Judges apply it to seek an equitable result, but mootness in the constitutional sense is absent.

Article III, section 2 of the U.S. Constitution bars federal courts from hearing matters that are moot, because no case or controversy exists. But, in contrast, equitable mootness applies when courts voluntarily decline to hear matters even when cases or controversies are present. "[T]here is a big difference between *inability* to alter the outcome (real mootness) and *unwillingness* to alter the outcome ('equitable mootness'). Using one word for two different concepts breeds confusion." *In re UNR Indus., Inc.*, 20 F.3d 766, 769 (7th Cir.), cert. denied, 513 U.S. 999 (1994).

The U.S. Court of Appeals for the Seventh Circuit will consider if appeals should be dismissed on prudential grounds, but decided to "banish 'equitable mootness' from the (local) lexicon." *Id.* The U.S. Circuit Court of Appeals for the Third Circuit still utilizes the term "equitable mootness' while acknowledging the confusion the term can create. *See Samson Energy Res. Co. v. SemCrude, L.P.* (*In re SemCrude, L.P.*), 2013 U.S. App. LEXIS 17903 (3d Cir. Aug. 27, 2013). The Third Circuit says a better name would be "prudential forbearance." *Id.*, at *2, n.2.

Significantly, equitable mootness arises only when a debtor confirms a Chapter 11 plan of reorganization. In the typical fact pattern, a plan is confirmed and creditors opposing the plan appeal the confirmation order. The debtor urges the appellate judge to refuse the appeal on the basis that it is "equitably moot," asserting that reversal of the confirmation order could wreak havoc on the debtor's reorganization. A court that agrees with the argument can refuse to hear the appeal. If the creditors appeal that decision, the next appellate court will review the record to see if the court below had grounds to decline the appeal.

Two decisions in 2012 and 2013 by the Third Circuit demonstrate how the judge-made remedy is applied: the *SemCrude* decision cited above, and *In re Philadelphia Newspapers, LLC*, 690 F.3d 161 (3d Cir. 2012).

The *SemCrude* Decision

In July 2008, SemCrude, L.P. and affiliates (Debtors or SemCrude) filed for Chapter 11 in the U.S. Bankruptcy Court for the District of Delaware. SemCrude was in the oil and gas business. Suppliers to SemCrude filed claims in the case, asserted statutory liens, and started an adversary proceeding to challenge the Debtors' discharge of their claims. Given the number of suppliers (also known in the industry as producers) and their related claims, SemCrude asked the bankruptcy court to set global procedures to govern resolution of the suppliers' claims.

Certain suppliers objected to the Debtors' motion. They wanted their claims heard in an adversary proceeding, not in a larger group process. But Bankruptcy Judge Brendan Linehan Shannon granted the Debtors' motion and stayed the adversary proceeding. The suppliers filed an interlocutory appeal, but the District Court refused to hear it. The suppliers then appealed to the Third Circuit.

While all of this was taking place, the Debtors, a committee representing the interests of producers generally, and the Debtors' secured lenders settled the producers' claims. The Debtors incorporated the settlement into a plan of reorganization (Plan) and confirmed the Plan. The producers that had sought to bring an adversary proceeding to challenge the discharge of their claims appealed the confirmation order to the District Court. The Debtors objected, arguing that the appeal was equitably moot because the Plan had been confirmed. The District Court agreed with the Debtors and dismissed the appeal. *In re SemCrude, L.P.*, No. 09 Civ. 994, 2012 U.S. Dist. LEXIS 70551 (D. Del. May 21, 2012). The producers then appealed to the Third Circuit.

The Five-Part Test

The Third Circuit applies a five-part test to determine if an appeal should be dismissed based on equitable mootness:

> (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) (*en banc*). In *SemCrude*, the Third Circuit also noted that "[i]n practice, it is useful to think of equitable mootness as proceeding in two analytical steps: (1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation." 013 U.S. App. LEXIS 17903, *13.

Bankruptcy Code § 1101 defines substantial consummation as follows:

> (A) Transfer of all or substantially all of the property proposed by the plan to be transferred;
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> (B) Assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and
>
> (C) Commencement of distributions under the plan.

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If a plan has been substantially consummated, then the Third Circuit considers if "granting relief (allowing an appeal to proceed after confirmation) will require undoing the plan as opposed to modifying it in a manner that does not cause its collapse." *Id*. at *14. And the Third Circuit says that granting relief "should be the rare exception and not the rule." The Third Circuit also requires the party seeking to dismiss an appeal to prove the elements of equitable mootness.

In the Courts

With respect to the *SemCrude* appeal, the district court had ruled that the plan had been substantially consummated and that the appealing creditors had not obtained a stay. The Third Circuit agreed. But the district court had also decided that the appeal would "undermine the reorganization plan confirmed by the Bankruptcy Court and harm third parties." 2013 U.S. App. LEXIS 17903, *20. The Third Circuit said the evidentiary record did not support these findings and reversed and remanded the case to the district court.

In an opinion by Judge Thomas Ambro, the Third Circuit panel concluded that the Debtors' plan would not be undermined because the appellants did not seek to upset the settlement reached in the case. Instead, the appellants had sought to proceed with their adversary proceeding to challenge the discharge of their claims. The Third Circuit reviewed the relief the appellants had sought and noted that their success on appeal would not cause a "sufficient redistribution of assets to destabilize the financial basis of the settlement." *Id*., *23.

The Debtors had also argued that the proposed adversary proceeding could result in a class action lawsuit against the Debtors and "disrupt the litigation peace achieved by the settlement." *Id*., *23. But the Third Circuit said the evidentiary record did not reveal how disruption would come about. No class had been certified, and appellants had not shown how a class action would unravel the plan. "The perceived harms were at best speculative," the Third Circuit said. *Id*., *25.

Next, the appellants said the appeal would harm third parties: lenders, equity investors, customers, suppliers, and creditor constituencies. But the Third Circuit said the record did not support this argument and was "counterintuitive." For instance, the appellants argued that lenders would terminate a credit facility if the appeal succeeded. The Third Circuit, however, said termination of the credit facility would hurt the lenders and thus the appellants' argument lacked merit.

The Supreme Court has stated that "federal courts have a strict duty to exercise jurisdiction that is conferred upon them by Congress." *Quackenbush v. Allstate Ins. Co*., 517 U.S. 706, 716 (1996). In *SemCrude*, the appellants had sought to proceed with an adversary proceeding. The lower courts rebuffed the appellants' efforts and they sought appellate review. The Third Circuit said that refusing to hear their appeal would be the "antithesis of equity required for 'mootness.'" 2013 U.S. App. LEXIS 17903, *30.

Finally, the Third Circuit observed that its ruling allowing the appeal to continue was just a "procedural victory" for the appellants and that the appellants still had a "long road ahead" before they could prevail. They still had to show entitlement to an adversary proceeding and, if they wanted to pursue a class action, obtain a ruling for class certification, and ultimately prove the merits of their claims in litigation. "We take no position on the likelihood of Appellants achieving any of these results," the panel said. *Id*. at n.12.

The *Philadelphia Newspapers* Decision

The recent *SemCrude* decision followed another Third Circuit opinion on equitable mootness. *In re Philadelphia Newspapers, LLC*, 690 F.3d 161 (3d Cir. 2012). *The Philadelphia Inquirer* (*Inquirer*) had published articles about certain individuals and Charter School Management, Inc. (CSMI Parties). The CSMI Parties sued the *Inquirer*, Philadelphia Media Holdings, LLC (Philadelphia Media), and certain *Inquirer* employees in state court in Pennsylvania, asserting that the articles defamed them by allegedly misleading the public into believing the CSMI Parties had engaged in improper conduct.

Philadelphia Media and affiliates later filed for Chapter 11 in the United States Bankruptcy Court for the Eastern District of Pennsylvania. Post-petition, the debtors published more articles and an editorial with links to the articles that had been published pre-petition. The CSMI Parties filed administrative expense claims in each of the debtors' jointly administered bankruptcy cases. Each claim totaled more than $1.8 million. The claims asserted that the post-petition articles and editorial with the links "republished" the initial articles that were allegedly defamatory.

The debtors objected to the claims. Bankruptcy Judge Stephen Raslavich ruled that the administrative expense claims had no merit. The CSMI Parties appealed to the district court, and several weeks later the debtors confirmed a plan of reorganization. The district court refused to hear the appeal, ruling that the confirmation of the plan rendered the appeal equitably moot. The CSMI Parties appealed that decision to the Third Circuit.

The Third Circuit, also in a decision by Judge Ambro, disagreed with the district court that equitable mootness applied in this case. The plan had been substantially consummated, and the appellants had not obtained a stay of the confirmation order. Even so, the Third Circuit ruled that balancing the "equitable mootness factors calls for allowing this appeal to proceed. Though the Plan was substantially consummated in a definitional sense after the bankruptcy court denied the administrative expense requests, a ruling in favor of the CSMI Parties will not upset the Plan." 690 F.3d at 170. Significantly, the Third Circuit noted that the plan reserved funds to pay administrative expense claims. Thus, if the CSMI Parties were found to hold valid claims, those claims could be paid post-confirmation without harm to the plan. *Id*.

The Third Circuit also said the CSMI Parties should not be faulted for failing to obtain a stay in these circumstances. Again, since the debtors had funds reserved to pay allowed administrative expense claims, "the CSMI Parties' posting of a bond was not critical to the Debtors or the entities designated to administer the Plan." *Id*. at 171. Finally, the Third Circuit said the appeal would not prejudice other creditors. They would also be protected from valid administrative claims by reserves set up in the Plan. *Id*.

Conclusion

Equitable mootness, or prudential forbearance, comes up only when a party appeals a confirmation order and a debtor argues that the appellate court should decline jurisdiction. The appellate court must decide if it should deny the appellant its jurisdictional right to proceed before that court. Recent Third Circuit cases reveal the significant hurdles a debtor faces when seeking to bar an appeal. Equitable mootness requires a concrete showing that reversal of a confirmed and consummated plan would produce significant harm to other parties or produce an unwieldy situation for the bankruptcy court.