

# Lending to the Emerging Debtor in the Face of an Appeal

By Steven B. Levine and Gopal K. Balachandran

Under the doctrine of equitable mootness, an appeal seeking to overturn an essential element of a substantially consummated plan will likely be dismissed.

To emerge successfully from bankruptcy, a debtor must cross many hurdles. The debtor must negotiate with various creditor constituencies, propose a confirmable plan of reorganization and, perhaps most important, secure stable exit financing. Even after a reorganization plan has been confirmed, there still exist pitfalls for both debtors and their lenders. In many Chapter 11 cases, there is at least one unhappy constituency that loudly proclaims that it will appeal the plan all the way to the U.S. Supreme Court as it exits the confirmation hearing. Can a lender ever extend exit financing in the face of an almost certain appeal? Yes, but not without being willing to accept some risk.

Under the doctrine of equitable mootness, lenders can often take comfort that an appeal seeking to overturn an essential element of a substantially consummated plan will likely be dismissed. This is especially the case if the party challenging the confirmation order fails to seek or obtain a stay. However, as a recent Sixth Circuit case demonstrates, lenders can never be fully certain that an appeal will be dismissed.<sup>1</sup> Thus, for lenders, particularly senior secured lenders who tend to be fundamentally risk averse, the decision to lend in the face of an appeal can be a difficult one.

## Equitable Mootness

Under the equitable mootness doctrine, a court may dismiss an appeal from a confirmation order if it is impractical and imprudent to upset a plan of reorganization.<sup>2</sup> Dismissal on equitable mootness grounds is appropriate when relief cannot be granted “without knocking the props out from under” the confirmed plan. In more colloquial terms, an appeal should be dis-

missed when the court cannot “unscramble the eggs” or “put Humpty Dumpty back together again.”

Perhaps the leading case in this area is *In re Continental Airlines*. The *Continental* court affirmed the dismissal of an appeal on equitable mootness grounds when, even though effective relief could conceivably be granted to the appellants, such relief would have been inequitable to the third-party lenders and other parties who had relied on the confirmation order. The court determined that it would be “neither prudent nor equitable to the plan of reorganization.”<sup>3</sup>

Although the criteria have been expressed differently, courts in the First, Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth, Eleventh and D.C. circuits have adopted versions of the equitable mootness doctrine.<sup>4</sup>

All these courts cite three key factors:

1. Whether the plan has been substantially consummated
2. Whether the relief requested on appeal would affect the rights of third parties who relied on the confirmation order
3. Whether a stay has been obtained

## Substantial Consummation and Reliance

Of these factors, the most important ones in practice have been whether the plan has been “substantially

---

*Steven B. Levine is a Partner in Brown Rudnick's Bankruptcy & Finance Group. Contact him at [slevine@brownrudnick.com](mailto:slevine@brownrudnick.com).*

*Gopal K. Balachandran is an Associate in Brown Rudnick's Bankruptcy & Finance Group. Contact him at [gbalachandran@brownrudnick.com](mailto:gbalachandran@brownrudnick.com).*

consummated” and the extent to which third parties have relied on the confirmation order. “Substantial consummation” is defined in the Bankruptcy Code as (1) a transfer of substantially all of the property to be transferred pursuant to the plan, (2) an assumption by the debtor or its successor of the business or management of the property dealt with by the plan or (3) a commencement of distribution under the plan. Achieving substantial confirmation often involves third parties that provide financing, purchase estate assets or otherwise do business with the reorganized debtor in reliance on the finality of the confirmation order.

Equitable mootness is especially appropriate when the plan involves intricate transactions with several third parties.<sup>5</sup> This is illustrated by a recent decision appealing the confirmation order in the first U.S. Airways bankruptcy.<sup>6</sup> After denying the Airline Pilots Association’s request for a stay, the Fourth Circuit dismissed its appeal as equitably moot citing the reliance interests of the third-party exit lenders and investors and others who had provided goods and services to the reorganized debtor or otherwise changed their position in reliance on the confirmation order.<sup>7</sup>

The *Continental Airlines* case provides another illustrative example.<sup>8</sup> In *In re Continental Airlines*, a group of aircraft lessors had objected to confirmation on the grounds that they were entitled to adequate protection in the form of an approximately \$123 million cash deposit reflecting the alleged decline in the market value of their aircraft collateral. This objection was denied by the bankruptcy court, which found that there had been no decline in the market value of the aircrafts. The district court dismissed the lessors’ appeal on equitable mootness grounds and the Third Circuit affirmed the dismissal. Both courts held that, although effective relief could conceivably have been granted to the lessors, such relief would be prejudicial to Continental’s exit lenders and various other third parties who had relied on the confirmation order and done business with *Continental* in the several years following confirmation. The exit lenders had specifically conditioned the financing on the bankruptcy court’s denial of the lessors’ adequate protection claim. These factors weighed heavily in favor of mootness. Perhaps even more heartening to exit lenders was the court’s strong declaration that “reliance on bankruptcy court confirmation orders” was the “central animating force behind the equitable mootness doctrine” and that public policy “clearly” weighed in favor of encouraging such reliance.<sup>9</sup>

## Seeking a Stay

---

In practice, the third factor, seeking and obtaining a stay, is less important. While courts have frequently cited the fact that a stay was not timely sought or granted in dismissing an appeal, failure to seek or obtain one is not fatal to the appellant’s ability to proceed.<sup>10</sup> Conversely, seeking a stay does not preclude a finding of mootness. As one court stated, “A stay not sought and a stay sought and denied lead equally to the implementation of a plan reorganization.”<sup>11</sup> Indeed, the Third Circuit has noted that the stay factor is largely duplicative of the substantial consummation factor.<sup>12</sup>

A conservative lender might choose to wait until the 10-day appeals period has lapsed or final action on a request for a stay is taken by the court. If a stay is granted, the plan and the exit financing cannot proceed until the appeal is decided or the stay is lifted. If a stay is not sought or the request for one is denied on the merits, the lender can take a degree of additional comfort under the equitable mootness case law. However, if the debtor and lender elect to go forward and consummate the plan and fund the exit loan before a stay is sought or while a request for one is pending, there will be nothing for the court to stay to preserve the status quo. In any event, the case law indicates that the key factor is not whether a stay is sought or obtained but whether the plan has been substantially consummated and it is too late for the court to “unscramble the eggs” without damaging the legitimate reliance interests of third parties.

## Exceptions to Equitable Mootness

---

The case law does recognize an exception to the equitable mootness doctrine. In instances when appeals involve a discrete issue, the adjudication of which can be resolved without the entire plan being toppled, courts have been more willing to reach the merits of the claim. In *In re PWS Holding Corp.*, the Third Circuit permitted an appeal challenging the propriety of third-party releases under a plan to proceed where it found that such releases could be eliminated without unraveling the entire plan of reorganization.<sup>13</sup> Similarly, in *In re Zenith*, the Third Circuit did not dismiss an appeal involving an award of \$76,500 in professional fees in the context of a \$300 million bankruptcy plan.<sup>14</sup>

While this exception appears narrow in scope, in practice it can be used to justify a review of a critical plan provision as the *American HomePatient* case illustrates. This case involved an appeal by a secured creditor challenging the interest rate and collateral valuation used by the court in approving a plan under which its claim was the subject of a cramdown. Even though the appellant did not seek a stay and the plan had been substantially consummated, the Sixth Circuit Court of Appeals refused to dismiss the appeal on the grounds that the bankruptcy court record did not definitively establish that the debtor could not pay the substantially increased debt service that would be due if the secured creditor prevailed. The appellate court ultimately upheld the bankruptcy court's rulings on the substantive cramdown issue on the merits.<sup>15</sup> However, if *HomePatient* had received exit financing and the appeal had been sustained, the lender could have found itself with a loan to a borrower with a much higher debt-service burden than it had agreed to fund.

## Recent Experience

Recently, we represented a lender in conjunction with its provision of exit financing to an emerging debtor. The lender was aware that a prepetition secured creditor group would almost certainly object to the debtor's plan of reorganization on the grounds that the plan did not afford the prepetition secured creditors adequate protection for an alleged decline in the value of their secured position during the case. The bankruptcy court denied this objection in confirming the plan, holding that the bank group had received all the adequate protection to which it was entitled. The creditor appealed and its request for a stay was denied by the bankruptcy court and the U.S. District Court acting as appellate court. Both courts cited the availability of relief against a related debtor not included in the plan as one of their grounds for denial. Thus, our client was squarely confronted with the dilemma of whether to lend despite the pendency of the appeal.

We were asked to help our client evaluate and manage this potential risk. First, we sought to determine how easily the plan could be unraveled if the appeal were upheld without harming the reliance interests of our clients as exit lender and other third parties. In our judgment, the plan was sufficiently complex and

enough parties would rely on it that it could not be easily unwound without significant prejudice to our client and other third parties. Second, we reviewed the facts, the stay pleadings and the court's findings in denying the stay. We determined that even if the appellate court thought the appeal had merit, it could still fashion effective relief and not disturb the plan by providing additional adequate protection against a related debtor. Tellingly, the appellant itself admitted that such relief was available. Thus, while there is no way to predict what a court will do in any specific case with absolute certainty, we were able to advise our client that the risks of an appeal were relatively small.

Based on this risk assessment, our client decided to proceed to close the exit financing. It was guided in this decision by the belief that if it chose not to provide financing under these circumstances, one of its competitors would likely have accepted the risks of an appeal and made the loan.

## Protection for Funds Advanced

Assuming that the lender decides to fund, would it be protected for any funds advanced to the postbankruptcy debtor? Unfortunately, there is no provision of the Bankruptcy Code that expressly preserves the rights of exit lenders in an appeal in the same way that Sections 363(m) and 364(e) protect liens and other rights granted to debtor-in-possession lenders and prepetition secured creditors as adequate protection for use of their cash collateral. Nor are there any reported decisions establishing the priority of the claims or liens of an exit lender as against creditors whose claims may be revived if a confirmation order is overturned on appeal. This issue appears never to have arisen in the reported case law. Rather, courts have uniformly cited the existence of the exit loan and the reliance interests of the exit lender as reasons to dismiss the appeal as equitably moot.

## Assessing the Risk

To be sure, a lender who provides exit financing as part of a complex reorganization can take some comfort from the equitable mootness case law. However, as *American HomePatient* shows, appellate courts have lots of discretion in determining whether an appeal is equitably moot. No lawyer can provide a

guarantee (or even a firm legal opinion) regarding dismissal. This uncertainty can be troubling to lenders, particularly senior secured lenders faced with the decision of whether to lend knowing an appeal is coming or to walk away from a profitable piece of business. However, through a careful analysis of the facts involved in the specific case, lawyers can help their clients properly gauge the risk.

### Endnotes

<sup>1</sup> *In re American HomePatient, Inc.*, 420 F3d 559, 563–65 (2005).

<sup>2</sup> *In re UNR Indus., Inc.*, CA-7, 20 F3d 766, 769 (1994).

<sup>3</sup> *In re Continental Airlines*, CA-3, 91 F3d 553, 560 (1996).

<sup>4</sup> See, e.g., *In re Genesis Health Ventures, Inc.*, 280 BR 339 (Bankr. D. Del. 2001); *Nordhoff Investments, Inc. v. Zenith Elecs. Corp.*, CA-3, 258 F3d 180 (2001); *In re Arnold & Becker Farms*, CA-9, 85 F3d 1415, 1419 (1996); *In re Public Serv. Co.*, 963 F2d 469, 473 note 13 (1st Cir. 1992); *In re Chateaugay Corp.*, 988 F2d 322 (2d Cir. 1993); *Central States, Southeast & Southwest Areas Pension Fund v. Central Transp., Inc.*, CA-4, 841 F2d 92 (1988); *In re Manges*, CA-5, 29 F3d 1034 (1994), *cert. denied*,

SCt, 513 US 1152 (1995); *In re Roberts Farms, Inc.*, CA-9, 652 F2d 793 (1981); *In re Club Assocs.*, CA-11, F2d 1065, 1069 (1992); *In re AOV Indus.*, CA-DC, 792 F2d, 1140, 1147–48 (1986); *In re Long Shot Drilling, Inc.*, BAP-10, 224 BR 473, 479 (1998); *Osmar Sylvania*, 2004 U.S. Dist. LEXIS 20600\*7 (D.Del. 2004); *In re American HomePatient, Inc.*, *supra* note 1; *supra* note 2.

<sup>5</sup> *Continental*, *supra* note 4, 91 F3d, at 562–63.

<sup>6</sup> *In re US Airways Group Incorporated*, CA-4, 369 F2d 806 (2004).

<sup>7</sup> See *id.*, at 810.

<sup>8</sup> *Supra* note 4, at 553, 560.

<sup>9</sup> *Id.*, at 565.

<sup>10</sup> *In re Shawnee Hills, Inc.*, CA-4, 125 F2d 466 (2005) (failure to seek a stay); *In re Genesis Health Ventures, Inc.*, *supra* note 5 (stay not sought until nine days after plan's effective date); *Macpanel Company v. Virginia Panel Corporation*, CA-4, 283 F3d 622 (2002) (failure to seek a stay).

<sup>11</sup> See *In Re Longshot Drilling, Inc.*, *supra* note 5.

<sup>12</sup> See *In Re Zenith*, CA-3, 329 F3d 338, at 347 (2003).

<sup>13</sup> *In re PWS Holding Corp.*, CA-3, 228 F3d 224 (2000).

<sup>14</sup> *Supra* note 13.

<sup>15</sup> *Supra* note 1.

a Wolters Kluwer business

This article is reprinted with the publisher's permission from the COMMERCIAL LENDING REVIEW, a bi-monthly journal published by CCH INCORPORATED. Copying or distribution without the publisher's permission is prohibited. To subscribe to the COMMERCIAL LENDING REVIEW or other CCH Journals please call 800-449-8114 or visit [www.tax.cchgroup.com](http://www.tax.cchgroup.com). All views expressed in the articles and columns are those of the author and not necessarily those of CCH INCORPORATED or any other person.