Bankruptcy Courts' Equitable Discretion May Be In Danger

By **Brian Shaw and Mark Radtke** (September 20, 2021, 2:44 PM EDT)

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A bankruptcy court's ability to exercise discretion is critically important to the equitable and pragmatic goals of bankruptcy jurisprudence. So too is the finality of bankruptcy court orders approving asset sales and confirmed plans. Both concepts are baked into the fabric of the bankruptcy system, and most practitioners would consider them and their related doctrines, important tools in the general bankruptcy toolbox.

But concern is growing from various sectors of the bankruptcy community that the misuse of these tools is becoming all too common, if not the norm.

Both Congress and some higher courts have flagged what they believe is abuse of that equitable discretion and have shown their willingness to restrict that flexibility. And regardless of whether you agree with them, practitioners and courts alike should take note of the tone of these congressional and judicial inquiries, and the conundrum they pose for practitioners and judges.

Ultimately, it may leave some practitioners and courts with a very real conundrum: The aggressive assertion or acceptance of a discretionary, equitable doctrine, which beneficially serves a particular client or case, may also harm the bankruptcy system overall.

A recent decision, In re: VeroBlue Farms USA Inc., by the U.S. Court of Appeals for the Eighth Circuit reflects this very concern.[1]

The VeroBlue court significantly scaled back the application of equitable mootness — or what it preferred to call equitable dismissal — for bankruptcy appeals.[2] Its decision is binding on all the federal courts over which it exercises appellate review and supervisory authority.[3]

And for all practical purposes, unless VeroBlue is reversed by the U.S. Supreme Court, in the Eighth Circuit the tool of equitable mootness has been reduced from a sledgehammer to a tack hammer.

Specifically, the Eighth Circuit held that "only in extremely rare circumstances" should a district court — or a court of appeals reviewing a Bankruptcy Appellate Panel decision — "invoke equitable mootness to preclude a party whose rights have been impaired by a Chapter 11 confirmation order from obtaining supervisory review of the merits of the plan by an Article III court that has an 'unflagging obligation' to exercise its appellate jurisdiction."[4]

In other words, judges should do their job and not simply dismiss appeals from plan confirmation orders because a plan has been consummated.

The judge-made doctrine of equitable mootness recognizes that "even when the moving

party is not entitled to dismissal on Article III grounds, common sense or equitable considerations may justify a decision not to decide a case on the merits."[5] But the invocation of the doctrine is supposed to be the exception, not the rule.

U.S. Circuit Judge Cheryl Ann Krause has opined that "this problematic doctrine (equitable mootness) has lured us into abdicating our jurisdiction when we should be exercising it, and stunting the development of ... bankruptcy jurisprudence when it's our duty to promote it."[6] Judge Krause is certainly not alone in her criticism of the doctrine's misuse.

The VeroBlue court noted that the equitable mootness doctrine has been frequently applied and thoughtfully criticized by many circuit judges.[7] So much so, that it predicts the Supreme Court may step in and severely curtail or abolish the use of equitable mootness in order to restore the Article III-based rule that jurisdiction should be exercised.[8]

The elimination of the doctrine would be a shame because it is a tool that serves a worthy purpose when applied properly. While the Eighth Circuit's ruling binds only certain federal courts, its Supreme Court prediction serves as a reminder — or, more aptly, a warning — for all who practice and adjudicate in the bankruptcy arena that the misuse of discretion may lead to the loss of it.

The Supreme Court has not yet granted certiorari on the equitable mootness issue, but the opportunity currently exists if it wishes to do so. Regardless of VeroBlue, two pending certiorari petitions already seek to challenge the validity of equitable mootness with respect to bankruptcy appeals.[9] GLM DWF Inc. v. Windstream Holdings Inc. comes out of the U.S. Court of Appeals for the Second Circuit,[10] and Hargreaves v. Nuverra Environmental Solutions Inc. is from the U.S. Court of Appeals for the Third Circuit.[11]

The Supreme Court is scheduled to consider these petitions on Sept. 27. We may therefore soon learn whether the Eighth Circuit's prediction comes true.

These petitions bear watching, not only for their potential implications for the doctrine of equitable mootness, but also for potentially broader implications on the key bankruptcy principles of equity and finality and the Supreme Court's willingness to clip the bankruptcy courts' discretionary wings.

The VeroBlue case may join the fray and bears watching too. But even if nothing further comes of these appeals, their underlying opinions should be heeded as they are easily applicable to other discretionary areas of bankruptcy jurisprudence such as third-party releases, gifting, unfair discrimination, improper classification, expedited cases and venue that are currently, or have in the past, come under similar scrutiny.

VeroBlue: Equitably Sweeping the Merits Away

The VeroBlue debtors farmed and sold fish to wholesalers, restaurants and grocery chains.[12] The business was relatively short-lived from its inception in 2014 to its voluntary filing for Chapter 11 in September 2018.[13] By the time of the filing, the debtors had accrued senior secured debt of $54 million that was well in excess of the value of the debtors' assets.[14] The debtors' complicated past and insider-led restructuring plan fueled various disputes in the bankruptcy court.[15]

In addition to the debtors, the key players in this story included: Broadmoor Financial LP, the entity that acquired the credit facility in December 2017; FishDish LLP, a preferred shareholder that invested $6 million in the summer of 2016; and Alder Aqua Ltd., which

wore many hats.[16]

Alder Aqua was a preferred shareholder that invested $28 million in the summer of 2016, a $5 million participant in the debtors' credit facility, the protagonist of a board takeover resulting in the termination of the company's founders and the resignation of FishDish's principal, the debtors' debtor-in-possession lender for $2 million, and the plan sponsor.[17] Through the plan, the debtor cancelled their existing preferred and common stock, and Alder Aqua became the sole shareholder of the reorganized debtor and assumed its management.[18]

The U.S. Bankruptcy Court for the Northern District of Iowa confirmed the debtors' plan over the objection of FishDish.[19]

On appeal of the confirmation order, FishDish argued that the plan:

- Unfairly discriminated between members of the same class of shareholders;
- Violated the absolute priority rule;
- Was proposed in bad faith;
- Was not in the best interests of creditors because of the failure to investigate and value the debtors' claims against Broadmoor, Alder Aqua and others for breaches of fiduciary duty, corporate waste and usurpation of corporate opportunities, equitable subordination or recharacterization of Broadmoor's claim, and fraud; and
- Was not feasible because Alder Aqua did not adequately fund it.[20]

FishDish did not seek a stay pending appeal.[21] Without any examination of these fundamental plan confirmation issues, the U.S. District Court for the Northern District of Iowa dismissed FishDish's appeal as equitably moot.[22]

The Eighth Circuit was displeased with that result, in general, and the lack of any inquiry into FishDish's claims by the district court, in particular.[23] It noted how the equitable mootness doctrine often does not promote finality and instead promotes uncertainty and delay, because plan proponents rush to implement plans so that the merits of any challenge to a plan confirmation order may be dismissed as equitably moot.[24]

Suggesting that the VeroBlue facts may indicate that the use of equitable mootness, to cut off the review of FishDish's arguments, was part of the debtor's plan from early in its bankruptcy case, the Eighth Circuit explained its concerns:

Of the $12 million paid under the Plan to creditors, presumably from the $13.5 million in funding provided by Alder, one half was paid to Broadmoor, and Alder Aqua as plan sponsor assumed management of the reorganized Debtors. These appellees are not third parties that the equitable mootness doctrine is intended to protect. Moreover, the only transfer that did not take place was Alder Aqua's commitment to invest substantial working capital. ... And if the confirmed plan must be set aside on the merits, the district court may be able to fashion effective relief for those whose rights were impaired by the plan even if the business assets have been sold to a third party purchaser relying on the confirmed plan, such as disgorgement of the proceeds. We do not assume how these factual inquiries may be resolved. We decide only that the inquiry must be made.[25]

The court of appeals accordingly reversed the district court's decision and remanded the case to the district court for further review.[26]

Writing on a clean slate, the Eighth Circuit declined to adopt a multifactor test for equitable mootness like other sister circuits.[27] Instead, it set forth the bare minimum review of the merits of the appeal that must be undertaken to decide the ultimate question of "whether the Court can grant relief without undermining the plan, and thereby, affecting third parties."[28]

First, the Eighth Circuit specifies that the district court must determine the strength of the appellant's claims.[29] Second, the district court must determine the amount of time that would likely be required to resolve the merits of those claims on an expedited basis.[30] Finally, the district court must identify the equitable remedies available to avoid undermining the plan and causing harm to third parties.[31]

And notably, the Eighth Circuit does not require an appellant to seek or obtain a stay pending an appeal.[32] The court thus set out a process for mandatory review that should eliminate most self-fulfilling dismissals of confirmation orders on equitable mootness grounds.

Accordingly, while the possibility for dismissal on equitable mootness grounds remains in the Eighth Circuit, it is only available when no relief is possible without undermining the plan and harming true third parties.

The VeroBlue decision thus stands as the strongest message yet to practitioners and courts that equitable mootness will not be abused as a tool to evade appellate review of Chapter 11 confirmation orders.

It May Be Too Late to Save Equitable Mootness — But What About Judicial Discretion?

While the VeroBlue Court chose not to entirely eliminate the doctrine of equitable mootness, it remains to be seen if the Supreme Court will do so. After all, equitable mootness is not a doctrine of finality created by Congress, such as Bankruptcy Code Section 363(m) regarding sales and Section 364(e) regarding loans.[33] The cert petitions in both Nuverra and Windstream attack equitable mootness head on.

The question presented in Nuverra is "[w]hether the doctrine of equitable mootness is inconsistent with the federal courts' 'virtually unflagging' obligation to hear and decide cases within their jurisdiction."[34]

The Windstream petition presents similar questions as follows: (a) "Whether doctrine of equitable mootness is a valid doctrine that can be applied to deny appellate review of bankruptcy court orders that are not expressly mooted by statute and that do not directly involve a challenge to a confirmed plan" and (b) if the answer to the first question is yes, "what elements or factors govern the doctrine."[35]

While the Nuverra question could spell the end of equitable mootness if answered in the affirmative, the Windstream question is much more nuanced because, unlike Nuverra and VeroBlue, which involved appeals from plan confirmation orders, Windstream arises from an appeal of a critical vendor order that became equitably moot after plan confirmation and substantial consummation of the plan which occurred while the appeal was pending.[36]

The Nuverra petition has generated additional briefing prior to its scheduled consideration. Nuverra originally waived its right to respond but then was requested to do so by the Supreme Court.[37] In addition, on Aug. 31, 21 professors of law filed an amici curiae brief in support of the petitioner, David Hargreaves.[38] In their brief, the professors urge the Supreme Court to "grant the petition to rein in the lower courts' abdication of their jurisdictional obligations, promote the development of bankruptcy law, and level the playing field in bankruptcy cases."[39]

On Sept. 1, Nuverra filed its response brief in opposition.[40] With respect to the application of equitable mootness, Nuverra contends that every court of appeals applies the doctrine to reject bankruptcy appeals, acknowledges that the doctrine has been the subject of criticism, argues that the doctrine has narrowed over time in part because of that criticism, and asserts that it is now a "narrow" doctrine that courts apply "with a scalpel, not an axe."[41]

If applied correctly and consistently, Nuverra may have a fair point.

But the unified voices of 21 bankruptcy law professors demonstrate the strong belief by many that the doctrine is still not applied correctly or consistently throughout the country.

In reality, the exception has become a rule and it has become exceedingly difficult to obtain appellate review of plan confirmation orders. Not surprisingly, the criticism of the doctrine is not becoming subdued but is instead growing louder. We must wait to see if the expansive use of the equitable mootness doctrine will lead to its ultimate demise.

If the Nuverra, Windstream or VeroBlue cases are ultimately heard by the Supreme Court, they could give rise to various interesting questions pertaining not only to the doctrine of equitable mootness, but also to the policy considerations of discretion and finality in bankruptcy appeals.

Is equitable mootness inconsistent with Article III courts' mandatory jurisdiction? If equitable mootness is allowed to continue in existence, how narrow is the doctrine, and how are courts to apply it correctly and consistently?

Does the Second Circuit's five-factor test lead to an appropriate application of the doctrine?[42] Or is the Third Circuit's two-step analysis the correct approach?[43] Or perhaps the Eighth Circuit in VeroBlue hits the mark?[44]

Does equitable mootness only apply to plan confirmation orders as the U.S. Court of Appeals for the Fifth Circuit has once again recently noted in In re: Walker County Hospital Corp.?[45] Or is the Second Circuit correct in holding that "equitable mootness can be applied 'in a range of contexts,' including appeals involving all manner of bankruptcy court orders?"[46]

What does an appellant have to do — or is there anything it can do — to avoid a railroading of its appellate rights by the application of the equitable mootness doctrine?

We may soon find out the answers to some of these questions and others related to equitable mootness and the application of judicial discretion and pragmatism in bankruptcy cases.

The Ripple Effect Is Potentially Far Reaching

If the doctrine of equitable mootness is eliminated or scaled back significantly, the implications would likely be far reaching and while losing the particular tool would be bad for practitioners and bankruptcy courts alike, some good could arise from it. For example, as noted by the 21 law professors:

Merits review is particularly important for complex questions, like whether a plan comports with the Bankruptcy Code's cramdown provisions, an issue that often cries out for appellate review ... or claims involving conflicts of interest or preferential treatment that go to the very integrity of the bankruptcy process.[47]

Let's consider what they meant when they argued that reining in the doctrine of equitable mootness would promote the development of bankruptcy law and level the playing field in bankruptcy cases.[48]

With respect to the development of bankruptcy law, the professors argue that

The all-too-routine invocation of equitable mootness to dismiss appeals deprives bankruptcy law of the thoughtful analysis and predictable precedent that appellate review provides. In so doing, it leaves the development of that jurisprudence to a relatively small number of non-Article III bankruptcy judges who sit in the jurisdictions where the most complex bankruptcy cases are concentrated.[49]

The professors have a point, as every case of equitable mootness removes one or more issues from the pipeline of appellate review by Article III judges and precedential decisions.

So, for example, in Nuverra, the application of equitable mootness made the bankruptcy judge the ultimate arbiter. U.S. Bankruptcy Judge Kevin Carey decided that the Chapter 11 plan did not discriminate unfairly against the objecting unsecured creditor even though he received only 5 cents on the dollar, while other unsecured creditors received 100 cents.[50]

According to Judge Carey, this result was acceptable because the favored creditors received their additional 95 cent recoveries via a "gift" from the debtors' senior creditors out of estate property that would have otherwise been distributed to those senior creditors.[51] Equitable mootness kept these issues from appellate review.

Nuverra is not an aberration. Had the Eighth Circuit not forced the district court to review the merits of FishDish's claims in VeroBlue, FishDish's arguments regarding unfair discrimination, violation of the absolute priority rule, the plan proponent's bad faith, feasibility and other core plan confirmation principles would not have been subject to any appellate review.[52]

Rather, it would have suffered a fate similar to the appeal in In re: Pacific Lumber Co., where the U.S. Court of Appeals for the Fifth Circuit invoked equitable mootness to dismiss an appeal and did not resolve the merits of an appeal from a confirmed plan that raised issues regarding unfair discrimination and the arbitrary classification of unsecured claims "in order to gerrymander an affirmative vote on reorganization."[53]

And, in addition to its dismissal of the appeal in Windstream on equitable mootness grounds,[54] the Second Circuit previously did not review challenges to a confirmed plan's settlement and release of billions of dollars of claims against an insider.[55]

If the Supreme Court does not decide to take up the viability of equitable mootness and leaves a circuit split in place, that decision will add equitable mootness to the lengthening

list of issues that lead some debtors to exercise their discretion and file their bankruptcy cases in issue-specific venues where the local law and bench provide the opportunity for their desired outcome.

Debtors and their counsel understand that certain circuits, and in some cases, districts or divisions provide a significantly better opportunity for the confirmation of an aggressive plan. If they also know that they can quickly effectuate the plan and make its confirmation nonreviewable as a matter of law, they are going to have to strongly consider filing their case in that jurisdiction.

And now, discretion surrounding third-party releases and venue are already at issue as the Purdue Pharma LP bankruptcy plays out in the U.S. Bankruptcy Court, and on appeal, in the U.S. District Court for the Southern District of New York.[56]

Purdue Pharma's bankruptcy case has garnered national attention because of the third-party releases that were granted to members of the Sackler family, who owned Purdue Pharma and have been accused of making billions of dollars from reckless and greedy corporate practices with respect to the marketing and sale of OxyContin and the ensuing national opioid crisis.

Furthermore, on appeal of the confirmation order, it is likely that some form of equitable mootness argument will be raised by appellants in an effort to dismiss the appeal.

And under the current state of the law in the Second Circuit, appellate challenges to the bankruptcy court's approval of third-party releases in the Purdue Pharma confirmation order may suffer the same fate as the third-party release challengers in the In re: Charter Communications Inc. 2012 case: dismissal of the appeals on equitable mootness grounds and thus no appellate review of the third-party releases.

It is likely for this reason, on Sept. 15, the Office of the U.S. Trustee sought a stay pending its appeal of the order confirming the Purdue Pharma plan of reorganization and granting the Sackler third-party releases.[57]

It is cases like Purdue Pharma, not Nuverra, that receive national attention. But either case could lead to bankruptcy practitioners and judges losing some important equitable tools. Congress and the Supreme Court know how to scale back discretion and take away tools like equitable mootness and third-party releases.

The Supreme Court has the opportunity to exercise its authority in Nuverra and Windstream and dictate national policy with respect to equitable mootness. If equitable mootness is eliminated or severely scaled back, important bankruptcy issues such as third-party releases, unfair discrimination, gifting and expedited prepackaged bankruptcy cases would almost certainly see an increase in appellate review and the corresponding development of bankruptcy law.

Even if the Supreme Court declines the invitation to review the use of equitable mootness, members of Congress have already conducted hearings regarding Purdue Pharma.[58] For example, the use of equitable mootness as a weapon has also been the subject of a recent congressional subcommittee hearing.[59] Certain members of Congress have taken the initial steps to propose new laws regarding third-party releases and forum shopping.

In the U.S. House of Representatives and U.S. Senate, bills named the "Nondebtor Release Prohibition Act" have been introduced.[60] Members of the House also introduced the

"Bankruptcy Venue Reform Act."[61] The former would prohibit courts from granting third-party releases and the latter would severely limit a corporate debtor's ability to forum shop.

These laws may never leave committee let alone reach the president's desk, but that does not mean that the behavior leading to their introduction does not need adjustment if bankruptcy practitioners and courts want them to be available in the future.

Conclusion

With equity as the cornerstone of bankruptcy restructurings, at what point does the erosion of the ability to exercise equitable discretion make the bankruptcy process too rigid and unworkable? Bankruptcy practice and jurisprudence are not yet there. However, the warning bells have been rung.

Practitioners and the bench should be aware that many believe that the continued aggressive use of equitable discretion in bankruptcy cases will result in its elimination. But this awareness simply leads us back to the conundrum facing many under the current state of the law: The aggressive assertion or acceptance of a discretionary, equitable doctrine may benefit the particular client or case, but may also ultimately harm the bankruptcy system.

It does not necessarily have to be an either/or proposition. More often than not, both objectives can be served with a more thoughtful use of the available bankruptcy tools.

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[1] FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.), 6 F.4th 880 (8th Cir. 2021).

[2] Id., at 888.

[3] Thus, federal courts in Arkansas, Missouri, Iowa, Minnesota, North Dakota, South Dakota and Nebraska are directly affected, as are the cases pending before them.

[4] VeroBlue Farms, at 891.

[5] Id., at 888 (quotations omitted).

[6] Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.), 834 Fed. Appx. 729, 737 (3d Cir. Jan. 6, 2021) (Krause, J., concurring) (quotation omitted).

[7] VeroBlue Farms, at 889.

[8] Id., at 891.

[9] GLM DWF Inc. v. Windstream Holdings Inc., 21-78 (Sup. Ct.); Hargreaves v. Nuverra Environmental Solutions Inc., 21-17 (Sup. Ct.).

[10] GLM DWF Inc. v. Windstream Holdings Inc. (In re Windstream Holdings Inc.), 838 Fed. Appx. 634 (2d Cir. Feb. 18, 2021).

[11] Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.), 834 Fed. Appx. 729 (3d Cir. Jan. 6, 2021).

[12] VeroBlue Farms, 6 F.4th at 884.

[13] Id.

[14] Id.

[15] Id.

[16] Id., at 883-84.

[17] Id.

[18] Id., at 886.

[19] Id.

[20] Id.

[21] Id.

[22] Id.

[23] Id., at 889.

[24] Id.

[25] Id., at 889-90.

[26] Id., at 883-84.

[27] Id., at 889.

[28] Id. (quotations omitted).

[29] Id., at 890.

[30] Id.

[31] Id.

[32] Id. at 888.

[33] 11 U.S.C. §§363(m) and 364(e).

[34] Hargreaves v. Nuverra Environmental Solutions Inc., 21-17 (Sup. Ct.).

[35] GLM DWF Inc. v. Windstream Holdings Inc., 21-78 (Sup. Ct.).

[36] GLM DWF Inc. v. Windstream Holdings Inc. (In re Windstream Holdings Inc.), 838 Fed. Appx. 634 (2d Cir. Feb. 18, 2021).

[37] Hargreaves v. Nuverra Environmental Solutions Inc., 21-17 (Sup. Ct.).

[38] Id.

[39] Id.

[40] Id.

[41] Id.

[42] GLM DWF Inc. v. Windstream Holdings Inc. (In re Windstream Holdings Inc.), 838 Fed. Appx. 634, 636 (2d Cir. Feb. 18, 2021).

[43] Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.), 834 Fed. Appx. 729, 733 (3d Cir. Jan. 6, 2021)

[44] FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.), 6 F.4th 880 (8th Cir. 2021).

[45] Opinion, No. 515934518, at p. 6 n.4, In re Walker County Hosp. Corp., Case No. 20-20572 (5th Cir. July 12, 2021).

[46] Windstream Holdings at 637.

[47] In re One2One Comm'cns, LLC, 805 F.3d 428, 454 (3d Cir. 2015).

[48] Hargreaves v. Nuverra Environmental Solutions Inc., 21-17 (Sup. Ct.).

[49] Id.

[50] Id.

[51] Id.

[52] Id.

[53] In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009).

[54] GLM DWF Inc. v. Windstream Holdings Inc. (In re Windstream Holdings Inc.), 838 Fed. Appx. 634 (2d Cir. Feb. 18, 2021).

[55] In re R2 Invs. V. Charter Comm'cns, Inc. (In re Charter Commc'ns, Inc.), 691 F.3d 476 (2d Cir 2012).

[56] In re Purdue Pharma L.P., et al., Case No. 19-23649-RDD (Bankr. S.D.N.Y).

[57] Id., at Dkt No. 3778.

[58] The Role of Purdue Pharma and the Sackler Family in the Opioid Epidemic: Hearing before the Committee on Oversight and Reform of House of Representatives, 116th Cong., 2d Sess. (Dec. 17, 2020).

[59] Adam J. Levitin, Written Testimony Before the H. Comm. On the Judiciary Subcomm. On Antitrust, Commercial, and Administrative Law 14 (July 28, 2021).

[60] Nondebtor Release Prohibition Act of 2021, H.R. 4777, 117th Cong (2021); Nondebtor Release Prohibition Act of 2021, S. 2497, 117th Cong (2021).

[61] Bankruptcy Venue Reform Act of 2021, H.R. 4193, 117th Cong (2021).