Chapman and Cutler LLP

Chapman Client Alert

February 22, 2019 Current Issues Relevant to Our Clients

Appeal of a Municipal Plan of Adjustment Held to Be Equitably Moot by the Ninth Circuit

"The reorganization train has left the station."[1] The US Court of Appeals for the Ninth Circuit (the *"Ninth Circuit"* or the *"Appellate Court"*) is the latest court in a developing line of case law to find that the doctrine of equitable mootness applies to prevent an aggrieved creditor from unwinding a substantially consummated Chapter 9 municipal bankruptcy plan.[2] In addition, the Ninth Circuit affirmed the determination by the United States Bankruptcy Court for the Eastern District of California (the *"Bankruptcy Court"*) that the Takings clause of the Fifth Amendment to the United States Constitution did not make the claim of the appellant non-dischargeable in a plan of adjustment under the facts and circumstances of the case. Parties wishing to seek an appeal of a plan of adjustment should make every effort to seek a stay pending appeal or risk having the appeal deemed equitably moot. For other constituencies in the bankruptcy proceeding that have relied upon or taken action in connection with the confirmed plan of adjustment, the ruling provides comfort that the plan will not be unwound in a deleterious way.

Background

The facts underlying the Ninth Circuit's decision are complicated, but the holding is not. After a long, contentious, and expensive process, in February 2015 the City of Stockton, California, emerged from bankruptcy when its bankruptcy plan of adjustment (the *"Stockton Bankruptcy Plan"* or the *"Plan"*) became effective. An aggrieved creditor of the City of Stockton, California (*"Stockton"*) sought to unwind the Stockton Bankruptcy Plan, asserting that the Plan failed to adequately treat his eminent domain claim.

The creditor's claim had arisen 15 years before Stockton filed its bankruptcy proceeding, when Stockton had taken action to condemn land owned by the creditor's family to build a road. The road was built, but the long and drawn-out state court process between Stockton and the creditor continued.

The creditor had asserted an inverse condemnation claim under the Takings Clause of the US Constitution against Stockton, and alleged that the market value of the parcel that had been taken by Stockton to build the road remained undetermined. The basis of the creditor's claim was that he had not received just compensation as required under the US Constitution. When Stockton filed its bankruptcy petition, the creditor had an unliquidated and unsecured money damage claim in the inverse condemnation proceeding, which had yet to be proven. However, "[a]s the bankruptcy court pointed out, given the various defenses available to the City, '[the creditor] has a very steep hill to climb in his action for greater compensation in the California courts.'"[3] The creditor filed a proof of claim in the bankruptcy proceeding, asserting an unsecured claim.

The creditor's claim remained outstanding, and Stockton filed its plan of adjustment, which contained numerous intricate settlements with parties, including unions, pension plan participants and retirees, bond creditors, and capital markets creditors. The Plan itself contained 20 different classes of creditors that were impaired. The creditor's claim had been classified as an unsecured claim in the Stockton Bankruptcy Plan, but the creditor asserted that his claim could not be impaired by virtue of the Fifth and Fourteenth Amendments of the United States Constitution. The Plan was confirmed by the Bankruptcy Court, overruling the creditor's objection, and the creditor's claim was adjusted under the Plan. The creditor did not seek a stay of the implementation of the Stockton Bankruptcy Plan, but he did file the appeal that was the subject of the Ninth Circuit's decision.

The Ninth Circuit Opinion

Equitable Mootness

In bankruptcy, an appeal is equitably moot if the proceeding presents transactions that are so complex or difficult to unwind that debtors, creditors, and third parties are entitled to rely on the final bankruptcy order.[4] As noted by the Ninth Circuit, courts generally identify four factors in determining whether or not an appeal is equitably moot, including (1) whether the litigant sought a stay of the relevant order pending appeal; (2) whether the plan has been "substantially consummated"; (3) the effects any remedy will have on other parties that are not before the court; and (4) "whether the bankruptcy court can fashion effective and equitable relief without completely knocking the props out from under the plan and thereby creating an uncontrollable situation for the bankruptcy court."[5]

Working through the four factors, the Ninth Circuit summarily found first that the creditor did not take action to seek a stay of the consummation of the Plan pending appeal, which the Appellate Court found "obligatory" and the failure of which "should result in dismissal."[6] The Ninth Circuit found the second factor of the test likewise clear because Stockton's plan of reorganization was, in fact, substantially consummated.

The Ninth Circuit then examined the third factor of the equitable mootness test—the effects any remedy will have on other parties that are not before the court—to find that a reversal of the Plan confirmation order would undermine the numerous settlements required to finalize the Stockton Bankruptcy Plan and would have a substantial impact on the essential services Stockton is able to provide to its citizens post-confirmation.

The creditor attempted to argue that he was only seeking a monetary remedy, but he did not persuade the Ninth Circuit (who believed he was trying to dismantle the Plan's confirmation). The court held that any monetary recovery would jeopardize Stockton's long-range financial plan forming the basis for the feasibility of its plan of adjustment.

Finally, the Ninth Circuit found that the Bankruptcy Court was not able to fashion equitable relief without undoing the Stockton Bankruptcy Plan. Without significant analysis, the court found that granting relief would "knock the props out from under"[7] the plan of adjustment and leave the Bankruptcy Court with an unmanageable situation on remand. However, the Ninth Circuit did not appear to go beyond considering the remedy of dismantling the Plan and did not seem to consider other forms of relief not asked for by the creditor.

Finding that none of the factors were in favor of the creditor and that the "reorganization train has left the station[,]"[8] the Ninth Circuit dismissed the appeal as equitably moot.

The Takings Clause

The Ninth Circuit's decision is also of note because it addresses the intersection between bankruptcy and the Takings Clause in the Fifth Amendment of the United States Constitution. The creditor had argued that because his claim arose from an eminent domain proceeding, and the property was therefore taken for a public use, his claim should be exempted from discharge under the plan of adjustment. The Ninth Circuit rejected this argument.

This is of interest because in the Detroit, Michigan municipal bankruptcy proceeding, the Bankruptcy Court had held that Detroit could not discharge pending claims for just compensation arising from already completed takings due to the Takings Clause of the US Constitution.[9]

The Ninth Circuit, however, held that the creditor's claims were not exempted from discharge under a confirmed plan of reorganization because "[t]he Takings Clause is only implicated in bankruptcy if the creditor has actual property rights. In other words, the creditor must have an 'in rem right under non-bankruptcy law to look to specific items of property' in order for the debt to be paid ahead of unsecured creditors."[10]

The Appellate Court found that the creditor had actually relinquished his property interest in the land parcel when the condemnation proceeding first commenced with respect to the creditor's property 15 years before Stockton's bankruptcy proceeding, due to the procedural posture of the underlying state court action.

Furthermore, the Ninth Circuit found that the creditor had relinquished any property right he had as a result of permitting Stockton to construct the road thereon. Allowing Stockton to complete the taking for public use in this way denied the creditor the right to enjoin Stockton. In the Ninth Circuit's view, the fact that formal title did not pass through the eminent domain proceeding was irrelevant—where a prior physical taking has occurred, the subsequent title transfer is merely a confirmation.

Holding that the creditor did not have a cognizable property interest (as his property rights were extinguished long before the bankruptcy was filed) and had only asserted an unsecured claim that was not tethered to an actual property interest, the Ninth Circuit held that the Bankruptcy Court correctly found his claim to be an unsecured claim and properly overruled his objection to confirmation of the Stockton Bankruptcy Plan.

Conclusion

As noted above, parties wishing to seek an appeal of a plan of adjustment should make every effort to seek a stay pending appeal or risk having the appeal deemed equitably moot. For other constituencies in the bankruptcy proceeding that have relied upon or taken action in connection with the confirmed plan of adjustment, the ruling provides comfort that the plan will not be unwound in a deleterious way.

For More Information

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1 *In re City of Stockton, California*, 909 F.3d 1256, 1265 (9th Cir. 2018).

2 Our earlier Chapman Client Alert, dated September 14, 2018, titled "Plan Opponents' Appeal Goes Down the Sewer—the Eleventh Circuit Holds the Ratepayers' Appeal in Jefferson County is Equitably Moot" (the "*Prior Alert*") can be found here. A writ of certiorari has been filed seeking Supreme Court review of the Jefferson County, Alabama decision.

3 *Stockton*, 909 F.3d at 1256, 1262.

4 *Stockton*, 909 F.3d at 1263, *citing JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Props., Inc. (In re Transwest Resort Props., Inc.)*, 801 F.3d 1161, 1167 (9th Cir. 2015) (quoting *Rev Op Grp. v. ML Manager LLC (In re Mortgs. Ltd.)*, 771 F.3d 1211, 1215 (9th Cir. 2014)).

5 *Stockton*, 909 F.3d at 1263, citing *Transwest*, 801 F.3d at 1167-68 (quoting *Motor Vehicle Cas. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 677 F.3d 869, 881 (9th Cir. 2012)).

6 *Stockton*, 909 F.3d at 1264. The Ninth Circuit noted, "Seeking a stay affords the bankruptcy court the opportunity to consider equitable factors, make a reasoned decision, and provide a decision and record which an appellate court can review. On the other hand, excusing a failure to seek a stay before the bankruptcy court allows a party to play possum, without consequence, while everyone else has materially changed positions in reliance on plan confirmation."

7 *Stockton,* 909 F.3d at 1265.

8 *Stockton,* 909 F.3d at 1266.

9 *In re City of Detroit*, 524 B.R. 147, 270 (Bankr. E. D. Mich. 2014); *see also Stockton*, 909 F.3d at 1273, n.7 (dissenting opinion).

10 *Stockton*, 909 F.3d at 1266, citing 4 *Collier on Bankruptcy* ¶ 506.03 (Alan Resnick & Henry J. Sommer eds., 16th ed. 2017).

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