Equitable Mootness and Arbitration: First Impressions in the Ninth Circuit

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2012 is shaping up as a year of bankruptcy first impressions for the Ninth Circuit. The court of appeals sailed into uncharted bankruptcy waters twice already this year in the same chapter 11 case. On January 24, the court ruled in *In re Thorpe Insulation Co.*, 2012 WL 178998 (9th Cir. Jan. 24, 2012) ("*Thorpe I*"), that an appeal by certain nonsettling asbestos insurers of an order confirming a chapter 11 plan was not equitably moot because, among other things, the plan had not been "substantially consummated" under the court's novel construction of that statutory term. Less than a week later, the Ninth Circuit ruled in *Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 2012 WL 255231 (9th Cir. Jan. 30, 2012) ("*Thorpe II*"), that a bankruptcy court has discretion in a core proceeding to decline to enforce an otherwise valid and applicable arbitration provision if arbitration would conflict with the underlying purposes of the Bankruptcy Code.

Mootness

"Mootness" is a doctrine that precludes a reviewing court from reaching the underlying merits of a controversy. In federal courts, an appeal can be either constitutionally or equitably moot. Constitutional mootness is derived from Article III of the U.S. Constitution, which limits the jurisdiction of federal courts to actual cases or controversies and, in furtherance of the goal of conserving judicial resources, precludes adjudication of cases that are hypothetical or merely advisory. In contrast, “equitable mootness” bars adjudication of an appeal when a comprehensive change of circumstances occurs such that it would be inequitable for a reviewing court to address the merits of the appeal.

In bankruptcy cases, equitable mootness is often invoked in an effort to preclude appellate review of an order confirming a chapter 11 plan. Protecting legitimate expectations of innocent stakeholders and the difficulty of “unscrambling the eggs” are issues that a court considers when confronted with any challenge to a plan-confirmation order, whether such challenge involves a request to revoke the order outright under Bankruptcy Code § 1144 (providing for revocation of a confirmation order within 180 days of entry upon a showing of procurement by fraud) or some form of collateral attack. Courts sometimes reject the challenge (if in the form of an appeal of the confirmation order) as equitably moot because it is simply too late or too difficult to undo transactions consummated under the plan.

A court will dismiss an appeal from a confirmation order as equitably moot if effective relief, even if arguably possible, would be inequitable under the circumstances, given the difficulty of restoring the *status quo ante* and the impact on all parties involved. The threshold inquiry in applying the equitable mootness doctrine is ordinarily whether a chapter 11 plan has been “substantially consummated.” Section 1101(2) of the Bankruptcy Code provides that substantial consummation occurs when substantially all property transfers proposed by the plan have been completed, the reorganized debtor or its successor has assumed control of the debtor’s business and property, and plan distributions have commenced.

Several circuit courts of appeal have formally adopted the doctrine of equitable mootness in considering whether to hear appeals of plan-confirmation orders. For example, in *Search Market Direct, Inc. v. Jubber (In re Paige)*, 584 F.3d 1327 (10th Cir. 2009), the Tenth Circuit considered six factors in determining whether the doctrine should moot appellate review of a confirmation order: (1) whether the appellant sought and/or obtained a stay pending appeal; (2) whether the plan has been substantially consummated; (3) whether the rights of innocent third parties would be adversely affected by reversal of the confirmation order; (4) whether the public-policy need for reliance on the confirmed bankruptcy plan—and the need for creditors generally to be able to rely on bankruptcy-court decisions—would be undermined by reversal of the confirmation order; (5) the likely impact upon a successful reorganization of the debtor if the appellant's challenge is successful; and (6) whether, on the basis of a brief examination of the merits of the appeal, the appellant's challenge is legally meritorious or equitably compelling. Substantially similar tests have been adopted by the Second, Third, and Fifth Circuits. *See In re Chateaugay Corp.*, 10 F.3d 944 (2d Cir. 1993); *Nordhoff Invs., Inc. v. Zenith Elecs. Corp.*, 258 F.3d 180 (3d Cir. 2001); *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228 (5th Cir. 2001). As discussed herein, the Ninth Circuit joined this group with its ruling in *Thorpe I*.

Arbitration of Disputes in Bankruptcy

Whether a contractual arbitration clause will be enforced by the bankruptcy courts in accordance with the Federal Arbitration Act (the "FAA") has been the focus of debate in bankruptcy and appellate courts for decades. The FAA provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

In *Shearson/Am. Exp. Inc. v. McMahon*, 482 U.S. 220 (1987), the U.S. Supreme Court ruled that the FAA's mandate may be overridden if a party opposing arbitration can demonstrate that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." According to the Court, such congressional intent can be discerned in one of three ways: (i) the text of the statute; (ii) the statute's legislative history; or (iii) "an inherent conflict between arbitration and the statute's underlying purposes."

Guided by this mandate, in the past, the consensus among most courts addressing the issue had been that a bankruptcy court can adjudicate a dispute otherwise subject to binding arbitration if the dispute falls within the court's "core" jurisdiction, but in all other cases it must defer to arbitration. However, the approach adopted by most circuit courts that have considered the issue is more nuanced. Rulings from the Second, Third, Fourth, Fifth, and Eleventh Circuits stand for the proposition that arbitration is the favored means of resolving disputes—even some that fall within the bankruptcy court's core jurisdiction. In these circuits, the focus of the inquiry has shifted from an analysis of core versus noncore to determining: (i) whether a dispute is core; and (ii) if so, whether referral of the dispute to arbitration would conflict with the underlying purposes of the Bankruptcy Code. *See Whiting-Turner Contracting Co. v. Elec. Mach. Enters., Inc. (In re Elec. Mach. Enters., Inc.)*, 479 F.3d 791 (11th Cir. 2007); *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006); *Mintze v. American General Financial Services, Inc. (In re Mintze)*, 434 F.3d 222 (3d Cir. 2006); *Phillips v. Congelton, L.L.C. (In re White Mountain Mining Co.)*, 403 F.3d 164 (4th Cir. 2005); *Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Mgmt. Corp. (In re Nat'l Gypsum Co.)*, 118 F.3d 1056 (5th Cir. 1997).

A matter falls within a bankruptcy court's "core" jurisdiction if it either invokes a substantive right created by federal bankruptcy law or could not exist outside a bankruptcy case. In contrast, "noncore" matters generally involve disputes that have only a tenuous relationship to a bankruptcy case and would in all likelihood have been litigated elsewhere but for the debtor's bankruptcy filing. If a dispute is core, a bankruptcy court can adjudicate it, subject to appeal (although the Supreme Court's recent ruling in *Stern v. Marshall*, 132 S. Ct. 56 (2011), means that certain kinds of core proceedings identified in 28 U.S.C. § 157(b)(2) cannot, as a matter of constitutional law, be adjudicated finally by a bankruptcy court). The court may also hear certain noncore disputes, provided they are "related" to the bankruptcy case, but must submit proposed findings of fact and conclusions of law to the district court for approval, unless the litigants agree otherwise.

In *Thorpe II*, the Ninth Circuit joined its sister circuits in holding that even core proceedings must be referred to arbitration unless referral of the dispute would inherently conflict with the underlying purposes of the Bankruptcy Code.

Thorpe Insulation

Thorpe Insulation Company is a California company that distributed, installed, and repaired asbestos insulation products between 1948 and 1972. Since the late 1970s, the company and its affiliates (collectively, "Thorpe") have faced approximately 12,000 claims and lawsuits for personal injury or wrongful death based on asbestos exposure. Over the years, Thorpe purchased insurance policies with many different companies covering claims for injuries caused by asbestos exposure. Beginning in 1978, Thorpe's insurers handled the defense of the asbestos suits and paid more than $180 million defending and indemnifying Thorpe, after which the insurers took the position that the policies' aggregate coverage limits were exhausted.

In 1985, Thorpe and one of its insurers, Continental Insurance Company ("Continental"), entered into a "Wellington Agreement," a comprehensive coverage and claims-handling agreement between a number of asbestos producers and their insurers. The Wellington Agreement provided for arbitration of any coverage dispute, an eventuality that was realized after Continental notified Thorpe in 1998 that its policy coverage was exhausted. An arbitrator ruled in Continental's favor, and the parties entered into a settlement agreement in April 2003 (the "Settlement Agreement"). In that agreement, Thorpe warranted that: (i) it would not assign any cause of action connected with the coverage dispute or any claim under the insurance policies, which were the subject of releases elsewhere in the agreement; and (ii) it would "not in any way voluntarily assist any other person or entity in the establishment of any claim . . . against [Continental] . . . arising out of . . . the matters released." Notably, the Settlement Agreement also provided that disputes under it were subject to arbitration.

As asbestos claims and litigation multiplied, Thorpe began negotiating, and ultimately reached settlements, with several insurance companies (other than Continental) with a view toward using a bankruptcy filing as a way to manage its mounting liabilities. As part of those settlements, the insurers agreed to assign their contribution, indemnity, and subrogation rights against Thorpe's other insurers (including Continental) to an asbestos trust to be established after Thorpe filed for bankruptcy. Thorpe also began collaborating with asbestos claimants to begin structuring an asbestos trust to be established in Thorpe's contemplated bankruptcy.

Continental claimed that Thorpe’s activities breached certain warranties in the Settlement Agreement. It accordingly demanded that the dispute be submitted to an arbitrator, who scheduled a hearing for October 16, 2007.

Thorpe filed for chapter 11 protection on October 15, 2007, in California. At the time of the bankruptcy filing, Thorpe estimated that 2,000 asbestos cases were pending against it and that many more were likely to be filed in the future. In May 2008, Thorpe, its official creditors’ committee, and the appointed legal representative for holders of future asbestos-related claims jointly proposed a chapter 11 plan contemplating: (i) the creation of a trust under section 524(g) of the Bankruptcy Code to handle asbestos claims; (ii) settlements with various insurance companies providing for more than $600 million in cash and securities to fund the trust; (iii) assignment by Thorpe of its rights in asbestos insurance policies to the trust; and (iv) the issuance of channeling injunctions barring the assertion of any asbestos-related claims (including indemnity claims) against various protected parties, including settling insurers.

The plan also stated that it was “asbestos neutral” because it preserved all “asbestos insurance defenses.” However, certain defenses, including the right to object to Thorpe’s assignment of its insurance-policy rights, were expressly precluded by the plan. Finally, the plan allowed asbestos claimants to assert their claims against either the trust or, with the trustees’ permission, non-settling insurers (“NSIs”).

Continental filed a proof of claim in Thorpe's bankruptcy case for damages arising from breach of the Settlement Agreement. It also moved to compel arbitration. The bankruptcy court denied the motion to compel in October 2008 and disallowed Continental's claim. The court determined that the allowance or disallowance of the claim was within its core jurisdiction pursuant to 28 U.S.C. § 157(b)(2). Acknowledging the "strong federal policy in favor of . . . arbitration," the court explained that, in core matters, it had "discretion in an appropriate case not to send it to arbitration." In the case before it, the court wrote that "the arguments that [Continental] wish[es] to advance are inextricably intertwined with the issues that the Court will have to address in connection with confirmation of [a chapter 11 plan]."

Continental appealed to the district court, which affirmed denial of the motion to compel arbitration, ruling that the bankruptcy court's findings "support the conclusion that arbitration of the claims would conflict with the underlying purposes of the Bankruptcy Code." However, the district court remanded the order denying Continental's claim to the bankruptcy court for additional findings. On remand, Continental refused to argue the issues and renewed its motion to compel arbitration, which the bankruptcy court denied and the district court affirmed on appeal. Continental appealed to the Ninth Circuit.

The bankruptcy court confirmed Thorpe's chapter 11 plan in February 2010. In doing so, the court held that, because the plan was insurance neutral, the NSIs lacked standing to object to many aspects of it. The court also ruled that the plan preempted the NSIs' state-law contract rights prohibiting assignment of Thorpe's rights under the insurance policies to the asbestos trust. Certain NSIs (including Continental) appealed the confirmation order, which was affirmed by the district court, with minor modifications, in September 2010. The plan became effective on October 22, 2010, after the Ninth Circuit denied the NSIs' emergency motion for a stay pending appeal but granted an expedited hearing on the merits. Thorpe immediately began implementing the chapter 11 plan, and the trust commenced processing claims and making distributions. In February 2011, Thorpe asked the Ninth Circuit to dismiss the appeal on the basis of mootness.

The Ninth Circuit's Rulings

Equitable Mootness

The Ninth Circuit reversed the lower courts' rulings on equitable mootness and standing but affirmed the preemption rulings with respect to assignment of insurance rights. According to the Ninth Circuit: (i) the NSIs had standing to object to the plan and appeal the confirmation order because the plan had "the potential substantially to impact [the NSIs] economically" and was not insurance neutral, thereby providing the NSIs with party-in-interest, or "bankruptcy," standing under section 1109(b) of the Bankruptcy Code; and (ii) the NSIs had both "constitutional" standing under Article III of the U.S. Constitution and "zone of interests," or "prudential," standing because: (a) the plan affected the NSIs' contractual rights, financial interests, and (potentially) litigation rights; and (b) as Thorpe's insurers, the NSIs were within the "zone of interests" protected by section 1109(b).

Acknowledging that "[w]e have not yet expressly articulated a comprehensive test" for equitable mootness, the Ninth Circuit "endorse[d] a test similar to those framed" by sister circuits that have adopted a mootness standard:

> We will look first at whether a stay was sought, for absent that a party has not fully pursued its rights. If a stay was sought and not gained, we then will look to

> whether substantial consummation of the plan has occurred. Next, we will look to the effect a remedy may have on third parties not before the court. Finally, we will look at 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.

Applying that standard, the court ruled that the NSIs' appeal of the plan-confirmation order was not equitably moot. First, the Ninth Circuit noted, this was not a case where the NSIs sat on their rights—they sought (and were refused) stays by the bankruptcy and district courts, the Ninth Circuit, and circuit justice Anthony Kennedy. Second, the court concluded that Thorpe's plan had not yet been substantially consummated because only $135 million (of $600 million) in settlement proceeds had been transferred by settling insurers to the trust. Third, the Ninth Circuit concluded that modification of the plan would not "bear unduly on the innocent." It rejected the plan proponents' argument that "any changes made to the plan would be inequitable because asbestos claimants voted on the plan relying on the transactions it created, and any change would unfairly affect the bargain they received." The question, the court explained, is not whether it is possible to alter a plan so that no third-party interests are affected, "but whether it is possible to do so in a way that does not affect third party interests to such an extent that the change is inequitable." According to the Ninth Circuit, the plan expressly contemplates that it may be modified after confirmation with the consent of the trust advisory committee and the representative of future asbestos claimants, who, together with the bankruptcy court, can ensure that any changes to the plan after remand are made in a way that is equitable to the stakeholders concerned.

Finally, and "most importantly," the Ninth Circuit determined that the bankruptcy court on remand could devise an equitable remedy short of totally upsetting the plan or "tip[ping] over the

§ 524(g) apple cart." This could entail requiring the plan proponents to contribute more to the trust, amending the plan to clarify that the trust-distribution procedures are not binding on direct suits against the NSIs, modification of the trust-distribution procedures, or directing that the trust be placed under new governance if the bankruptcy court credited the NSIs' contentions that the trust administrators were biased.

Preemption

The Ninth Circuit agreed with the lower courts that Congress expressly preempted, in section 541(c) of the Bankruptcy Code, the NSIs' contractual prohibition on assignment of their insurance policies to the trust. That section provides that "an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law . . . that restricts or conditions transfer of such interest by the debtor." Significantly, the court distinguished its earlier decision in *PG&E Co., v. Cal. ex rel. Cal. Dep't of Toxic Substances Control*, 350 F.3d 932, 937 (9th Cir. 2003), which the NSIs argued held that a plan could expressly preempt nonbankruptcy law only insofar as it "relates to financial condition." The court construed *PG&E* as relying only on Bankruptcy Code §§ 1123(a) and 1142(a)—which provide general rules and requirements for chapter 11 plans—as opposed to the specific prohibition on transfer restrictions found in § 541(c). The court also held that implied preemption would likewise apply to render unenforceable the contractual anti-assignment provisions because such provisions would "stand as an obstacle to completion of a successful § 524(g) plan."

Arbitration

Shortly afterward, the same panel of Ninth Circuit judges ruled that the bankruptcy court did not abuse its discretion by denying Continental's motion to compel arbitration. At the outset, the court noted that "[n]either the text nor the legislative history of the Bankruptcy Code reflects a congressional intent to preclude arbitration in the bankruptcy setting." Given the absence of any manifestation of such intent, the Ninth Circuit explained, "[w]e ask . . . whether there is an inherent conflict between arbitration and the underlying purposes of the Bankruptcy Code."

Examining the issue as a matter of first impression, the Ninth Circuit concluded that the core/noncore distinction is relevant, but not dispositive:

> "[N]ot all core bankruptcy proceedings are premised on provisions of the Code that 'inherently conflict' with the [FAA]; nor would arbitration of such proceedings necessarily jeopardize the objectives of the Bankruptcy Code." . . . We join our sister circuits in holding that, even in a core proceeding, the *McMahon* standard must be met—that is, a bankruptcy court has discretion to decline to enforce an otherwise applicable arbitration provision only if arbitration would conflict with the underlying purposes of the Bankruptcy Code.

The Ninth Circuit ruled that compelling arbitration of the dispute between Thorpe and Continental would conflict with the underlying purposes of the Bankruptcy Code. The court agreed with the lower courts' determinations that the dispute was a core proceeding—Continental filed a proof of claim and Thorpe objected to the claim, so that allowance or disallowance of Continental's claim was core under 28 U.S.C. § 157(b)(2)(B). In addition, the court explained, because the claim "disputed or affected" assets in the section 524(g) trust and the rights of other creditors, its resolution directly impacted the administration of the bankruptcy estate and was also within the bankruptcy court's core jurisdiction under 28 U.S.C. § 157(b)(2)(A).

The Ninth Circuit rejected Continental's argument that its claim was "independent of Thorpe's bankruptcy" and thus did not conflict with the Bankruptcy Code. It agreed with the lower courts' conclusion that Thorpe's alleged breaches of the Settlement Agreement were "inextricably intertwined" with its chapter 11 cases and that the bankruptcy court therefore had discretion not to send the claim to arbitration:

> The purpose of § 524(g) is to consolidate a debtor's asbestos-related assets and liabilities into a single trust for the benefit of asbestos claimants. . . . Congress intended that the trust/injunction mechanism be "available for use by any asbestos company facing . . . overwhelming liability." . . . Congress tasked bankruptcy courts with ensuring that § 524(g)'s "high standards" are met and gave them authority to implement and supervise this unique procedure. . . . A claim based on a debtor's efforts to seek for itself and third parties the protections of § 524(g) implicates and tests the efficacy of the provision's underlying policies. Because Congress intended that the bankruptcy court oversee all aspects of a § 524(g) reorganization, only the bankruptcy court should decide whether the debtor's conduct in the bankruptcy gives rise to a claim for breach of contract. Arbitration in this case would conflict with congressional intent.

Finally, the Ninth Circuit concluded that arbitration of a creditor's claim against a debtor, even if conducted expeditiously, "prevents the coordinated resolution of debtor-creditor rights and can delay the confirmation of a plan of reorganization." It accordingly ruled that arbitration of Continental's claim "would conflict with the purposes and policies of § 524(g) and the Bankruptcy Code as a whole."

Outlook

The Ninth Circuit has addressed mootness in various contexts before, but *Thorpe I* represents a departure in that the court of appeals for the first time expressly adopted a standard for equitable mootness in connection with a challenge to an order confirming a chapter 11 plan. The articulation of such a standard adds some clarity to an issue that was previously uncertain. *Thorpe I* also supports the proposition that non-settling insurers in an asbestos bankruptcy case should have a seat at the table as parties in interest in the proceedings. The Ninth Circuit's analysis of "insurance neutrality" in *Thorpe I* is consistent with the Third Circuit's approach to the same issue in *In re Global Indus. Technologies, Inc.*, 645 F.3d 201 (3d Cir. 2011). Like the Third Circuit, the Ninth Circuit ruled that the chapter 11 plan was not "insurance neutral" because it could have a substantial economic effect on the non-settling insurers.

Thorpe I is hardly an unqualified victory for insurers in asbestos cases. Plan proponents now have much less incentive to propose "insurance neutral" plans, and insurers may find that they must litigate insurance-related issues in bankruptcy court and risk adverse bankruptcy-court decisions that will have preclusive effect in subsequent coverage litigation. In addition, the preemption decision with respect to the assignability of insurance policies eliminates, at least in the Ninth Circuit, one objection that insurers typically raise in opposing an asbestos plan.

The Ninth Circuit's interpretation of the term "substantial consummation" in *Thorpe I* represents a significant departure from existing case law, because it focused not on the transfer of property *from the bankruptcy estate* to the asbestos trust and reorganized debtor, but instead on future settlement payments to be made *by third parties* (the settling insurers) under existing settlement agreements, all of which had been transferred to the asbestos trust at or shortly after the plan's effective date in 2010. On April 3, 2012, the Ninth Circuit denied a petition for rehearing en banc, modifying its opinion slightly on this point.

Thorpe II, although also groundbreaking in the Ninth Circuit, is consistent with the approach applied by the majority of courts in determining whether to defer to an arbitrator to resolve a dispute involving a debtor in bankruptcy.

Jones Day represents the official creditors' committee in *In re Thorpe Insulation*.