AMERICAN BANKRUPTCY INSTITUTE

2018 Southwest Bankruptcy Conference

What Are the Limits of Sale, Plan and Constitutional Mootness?

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CONCURRENT SESSION

2018

The Limits of Mootness (Constitutional, Statutory, and Equitable)

ABI Southwest Bankruptcy Conference
Las Vegas, NV
September 7, 2018
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The Sources of Mootness Law

- ***Constitutional*:** U.S. Const. Art. III, § 2, Cl. 1
  "The judicial Power shall extend to all Cases . . . [and] Controversies. . . ."
- ***Statutory*:** §§ 363(m) and 364(e)
  "The reversal or modification on appeal . . . does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith"
  "The reversal or modification on appeal . . . of a sale or lease of property does not affect the validity of a sale or lease . . . to an entity that purchased or leased such property in good faith"
- ***Equitable*:** *In re Roberts Farms, Inc.,* 652 F.2d 793, 797 (9th Cir. 1981)
  "[R]eversal of the order confirming the plan . . ., which would knock the props out from under the authorization for every transaction that has taken place, would do nothing other than create an unmanageable, uncontrollable situation for the Bankruptcy Court."

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Consequences of Mootness

- *U.S. v. Munsingwear,* 340 U.S. 36, 39-40 (1950)

  Established practice of the Supreme Court when a case becomes moot is vacatur of the lower court opinion "in order to prevent a judgment, unreviewable because of mootness, from spawning legal consequences."
- *United States Bancorp v. Bonner Mall*, 513 U.S. 18, 25 (1994)

  Losing party "frustrated by the vagaries of circumstance, ought not in fairness be forced to acquiesce in the judgment[,]" but losing party who settles "has voluntarily forfeited his legal remedy by the ordinary processes of appeal or certiorari, thereby surrendering his claim to the equitable remedy of vacatur."
- *Valero Terrestrial Corp. v. Paige*, 211 F.3d 112, 118 (4th Cir. 2000)

  Vacatur is entrusted to the discretion of the reviewing court, largely based on "fault" and "public interest."
- Restatement (Second) of Judgments § 28

  "relitigation of an issue in a subsequent action between the parties is not precluded [when]: (1) The party against whom preclusion is sought could not, as a matter of law, have obtained review of the judgment in the initial action."

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. . . Consequences of Mootness

- *Munsingwear vacatur* generally does not apply in bankruptcy mootness cases because the appellant is at fault (e.g., by not seeking a stay) or public policy
- If the party seeking vacatur does not request it from the appellate court, the mooted order will be treated as final
- Vacatur may not be appropriate in the case of bankruptcy mootness because the lower court order is legally required basis for the transactions
- *But see, Ind. State Police Pension Trust v. Chrysler LLC,* 558 U.S. 1087 (2009)
  - Supreme Court, after having declined to stay the order authorizing the sale of Chrysler's assets under § 363, granted petition for writ of certiorari seeking review of the Second Circuit's decision affirming the sale order, summarily vacated the judgment, and remanded the case to the Second Circuit "with instructions to dismiss the appeal as moot." *Citing, Munsingwear*
  - Subsequent decisions have interpreted it as vacating only the Second Circuit's precedential opinion, and not the underlying sale order. *See e.g., Miller v. Chrysler Group, LLC,* 2012 U.S. Dist. LEXIS 173791, 2012 WL 6093836 (D.N.J. Dec. 7, 2012)

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'Case or Controversy'

- The restraint on exercising federal judicial power dates from the early days of the Republic, when President George Washington (through Secretary of State Thomas Jefferson) posed 29 questions to the Supreme Court on how to maintain neutrality consistent with international law and treaties
- The Court declined: "The Lines of Separation drawn by the Constitution between the three Departments of Government—their being in certain Respects checks on each other—and our being Judges of a court in the last Resort—are Considerations which afford strong arguments against the Propriety of our extrajudicially deciding the questions alluded to; especially as the Power given by the Constitution to the President of calling on the Heads of Departments for opinions, seems to have been *purposely* as well as expressly limited to *executive* Departments."
- The Court later referred to this letter as an early authority on the "case or controversy" requirement. *Muskrat v. U.S.,* 219 U.S. 346, 354 (1911)
- Lies at the heart of cases on standing, mootness, ripeness and advisory opinions

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Origins of 363(m)

- Sale mootness has a long history at common law.
- *Gray v. Brignardello*, 68 U.S. 627, 634, 17 L. Ed. 693 (1863).

  "And, although the judgment or decree may be reversed, yet, all rights acquired at a judicial sale, while the decree or judgment were in full force, and which they authorized, will be protected. It is sufficient for the buyer to know, that the court had jurisdiction and exercised it, and that the order, on the faith of which he purchased, was made and authorized the sale. With the errors of the court he has no concern. These principles have so often received the sanction of this court, that it would not have been deemed necessary again to reaffirm them, had not the extent of the doctrine been questioned at the bar."

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History of Statutory Mootness

- Chandler Act (1938) authorized sales on terms similar to §363, but did not include a statutory mootness provision
- Bankruptcy Rule 805 was amended in 1976 to add mootness

  "Unless an order approving a sale of property or issuance of a certificate of indebtedness is stayed pending appeal, the sale to a good faith purchaser or the issuance of a certificate to a good faith holder shall not be affected by the reversal or modification of such order on appeal, whether or not the purchaser or holder knows of the pendency of the appeal."
- Advisory Committee Note stated that the amendment "is declaratory of existing case law." S*ee also, In re Abingdon Realty Corp.,* 530 F.2d 588, 590, 1976 (4th Cir. 1976)
- 1978 Code added the current provisions, which have never been changed

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Majority Stance: The *Per Se* Rule

- An appeal from a bankruptcy court's authorization of a sale or lease under section 363(b) or (c) is automatically moot if the appellant did not obtain a stay of the sale or lease pending appeal.
  - *Note:* it does not matter whether the appellant *sought* a stay of the sale order, only whether the appellant *obtained* a stay
- Adopted by the First, Second, Fourth, Fifth, Seventh, Eighth, Eleventh, and D.C. Circuits

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Third Circuit's Two-Part Test

- *Krebs Chrysler-Plymouth, Inc. v. Valley Motors*, Inc., 141 F.3d 490, 499 (3d Cir. 1998): Two prerequisites for statutory mootness to apply:

  (1) the underlying sale or lease was not stayed pending the appeal; and

  (2) the reviewing court cannot grant effective relief without affecting the validity of the sale or lease.
- *In re Swedeland Dev. Group, Inc., 16 F.3d 552, 559 (3d Cir. 1994):* Test also applies to §364(e)

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. . . Third Circuit

- Practical implication of Third Circuit test is that non-sale aspects of the transaction may not be moot
- *In re LCI Holding Co.,* 802 F.3d 547 (3d Cir 2015)
  - UCC and U.S. objected to 363 credit bid sale to lenders
  - UCC settled for $3.5 MM payment for unsecured creditors
  - IRS objected to the payment because its claim was senior
  - Held: the redistribution of the trust fund was not barred even if "it is integral to the transaction" because 363(m) "stamps out only those challenges that would claw back the sale from a good-faith purchaser."
- A version of this test has been adopted by the Tenth and Sixth Circuits. *In re C.W. Mining Co., 641 F.3d 1235 (10th Cir. 2011); In re Brown,* 851 F.3d 619 (6th Cir 2017)

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Ninth Circuit

- *In re Ewell*, 958 F.2d 276, 279 (9th Cir. 1992): Generally, appeal is rendered moot if appellant did not obtain stay pending the appeal of the sale order
- Notable exceptions:
  - Failure to obtain a stay won't render appeal moot: (1) where real property is sold to creditor subject to right of redemption, and (2) where state law would otherwise permit transaction to be set aside (*In re Mann*, 907 F.2d 923, 926 (9th Cir. 1990))
  - No proper finding of "good faith" means that appeal is not moot under 363(m), and sale order reversed (*In re Fitzgerald*, 428 B.R. 872, 881 (B.A.P. 9th Cir. 2010))

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Strange Examples where Statutory Mootness Held Not Applicable

- Mootness under 364(e) held not applicable because of "impermissible means of obtaining postpetition financing" *Matter of Saybrook Mfg. Co., Inc.*, 963 F.2d 1490, 1495 (11th Cir. 1992)
- Appeal from the lien-stripping portion of a sale order held not moot where both the senior and junior lienholders were parties to the appeal and the lien would be reattached to the property without negative consequences to anyone but the senior lienholder. *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC),* 391 B.R. 25, 42 (B.A.P. 9th Cir. 2008)
  - Validity of sale not affected fro 363(m) purposes where issue concerned whether a leasehold survived sale free and clear. *In re Spanish Peaks Holdings, II,* 862 F.3d 1148, 1153 n.4 (9th Cir 2017)

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Notice Problems

- *Citicorp Mortgage Co. v. Brooks*, 178 B.R. 198 (B.A.P. 9th Cir. 1995)
  - Protections under 363(m) and 364(e) may not protect a good faith purchaser/lender when no notice was given to the lienholder.
- *Elliott v. GM LLC*, 829 F.3d 829 (2d Cir 2016)
  - Upholding 'free and clear' shield, Bankruptcy Court held that purchaser at 363 sale could not be sued by purchasers of cars manufactured pre-sale for defect
  - The ignition-switch defect was known or reasonably ascertainable to GM when it filed for chapter 11 relief, and therefore due process required a mailed notice, not just publication, but the failure was non-prejudicial because there was not an effective economic recovery for those creditors in the case
  - Second Circuit reversed, holding that the purchaser was not insulated from pre-sale defects because defect creditors could have negotiated some relief at the sale approval stage

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. . . Notice Problems

- *Factors & Traders Ins. Co. v. Murphy,* 111 U.S. 738 (1884)
  - One of several secured noteholders was not given notice of a sale, and the Louisiana Supreme Court held that her lien survived the sale
  - U.S. Supreme Court reviewed, holding that there were two possible remedies: the forgotten noteholder could share with other noteholders or the entire sale could be set aside and the property re-sold in a proceeding at which all noteholders could be heard
  - But the remedy ordered by the Louisiana court could not be upheld: "It is not possible, consistently with any equitable view of the case, to hold that this sale discharged part of the liens against the property and increased thereby the value of other liens at the expense of the purchasers."

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Equitable Mootness

- Most commentators trace equitable mootness to *In re Roberts Farms, Inc.* 652 F.2d 793 (9th Cir. 1981) *(decided under the Act).*

  Court relied on Rule 805 (several properties were sold under the plan) and *Mills v. Green,* 159 U.S. 651 (1895), a case that dismissed an appeal seeking to enjoin the selection of a committee to attend a convention that had since taken place

  "Are we not quite patently faced with a situation where the plan of arrangement has been so far implemented that it is impossible to fashion effective relief for all concerned? Certainly, reversal of the order confirming the plan of arrangement, which would knock the props out from under the authorization for every transaction that has taken place, would do nothing other than create an unimaginable, uncontrollable situation for the Bankruptcy Court."

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Mootness in the Circuits

- Each Circuit Court of Appeals but the Eighth has adopted a version of equitable mootness, but no Circuit has adopted another Circuit Court's formulation
- Common elements:
  - whether the plan has been substantially consummated
  - whether a stay could have been sought/obtained
  - whether the relief requested would affect third parties who relied to their detriment on the plan or from whom it would inequitable to require disgorgement
  - whether the relief requested would affect the success of the plan or affect only a limited group; and
  - the public policy of affording finality to bankruptcy judgments

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Differences Among the Circuits

- Is there a presumption of mootness if the plan has been substantially consummated?
  - Yes: Second Circuit. *In re Charter Communications, Inc.,* 691 F.3d 476 (2d Cir. 2012)
  - No: Third Circuit. *In re Semcrude, L.P.,* 728 F.3d 314 (3d Cir. 2013)

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. . . Differences Among the Circuits

- What is the standard of review to apply to the lower court's determination?
  - Abuse of discretion, according to Second, Third and Fifth Circuits
  - *De Novo*, according to Fifth, Sixth, Ninth and Eleventh Circuits

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. . . Differences Among the Circuits

- Importance of Seeking a Stay
  - *Roberts Farms, supra,* "An entirely separate and independent ground for dismissal has also been established because Appellants have failed and neglected diligently to pursue their available remedies to obtain a stay . . . and have permitted such a comprehensive change of circumstances to occur as to render it inequitable for this court to hear the merits of the appeal."
  - Courts vary in the degree of diligence expected from the appellant, and of the importance attached to the failure to seek or obtain a stay
    - *In re Semcrude, L.P,* 728 F.3d 314, 322 (3d Cir. 2013) (where no stay was sought, stating "neither the Bankruptcy Code nor any other statute predicates the ability to appeal a bankruptcy court's ruling on obtaining a stay.")
    - *Nordhoff v. Zenith Electronics Corp*., 258 F.3d 180, 191 (3d Cir. 2001)(Alito, J. concurring in judgment affirming mootness of plan appeal) ("I am primarily influenced by the appellants' failure to seek a stay.")

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Bonding Problems

- In two prominent cases, courts established significant bonding requirements that the appellant did not post
  - *Tribune* and *Adelphia*
- Is it reasonable to expect a single creditor to underwrite the entire reorganization to protect their own, presumably limited, position?
- *Cf., Revel AC, Inc. v. IDEA Boardwalk LLC,* 802 F.3d 558 (3d Cir. 2015) (reversing district court decision not to grant a stay of debtor's attempt to use §363(b),(f) to sell free and clear of lessee's leasehold rights under §365(h); no mention of bond)

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Stay Problems

- Some courts have noted the unfairness of mooting appeals when the objecting party had no notice that the plan was being consummated

  See, e.g., Nordhoff Invs., Inc. v. Zenith Elecs. Corp., 258 F.3d 180, 191-2 (3d Cir. 2001) (Alito, J. concurring) ("I am primarily influenced by the appellants' failure to seek a stay. It is disturbing that Zenith, in a seeming attempt to moot any appeal prior to filing, succeeded in implementing most of the plan before the appellants even received notice that the plan had been confirmed. However, the plan was not entirely consummated when the appellants finally learned of the bankruptcy court's order. Most notably, the exchange of the old for the new bonds had still not been carried out. If the appellants had promptly applied for a stay, with or without posting a bond, when they finally got word of what the bankruptcy court had done, I would view this appeal differently. But the appellants never applied for a stay and have not provided an adequate explanation for their failure to do so.
- Should (i) plan proponents consummate immediately and seek a waiver of the 14-day stay, or (ii) give objectors a chance to seek a stay?
- If diligence is an element for the appellant, does that mean the appellant is at fault for not objecting to the waiver of the 14-day stay?

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Recent Evolution

- Following the Ninth Circuit's adoption of mootness in 1981, few other Circuits followed immediately
- The Third Circuit was among the first to adopt mootness, and has had an active judicial debate since
- *In re Continental Airlines*, 91 F.3d 553 (3d Cir. 1996) (7-6 en banc).

  One of the first major decisions outside the Ninth Circuit

  Then-Judge Alito authored the dissent, noting that Roberts Farms was based on former Bankr. Rule 805, which applied only to sales

  He would hear the appeal, then remand if the appeal were successful, understanding some remedies might be precluded

  Court adopted five-factor test
- *In re SemCrude,* 728 F.3d 314 (3d Cir. 2013)

  Criticized 5-factor test and reformulated basis for equitable mootness:

  "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 will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation ."

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Blue Pencil

- Some courts applied 'blue pencil' test to excise offending portions of a plan on appeal
  - *In re Zenith Elecs. Corp.,* 329 F.3d 338, 346-47 (3d Cir 2003) (appeal not moot where disgorgement of professional fees would not unravel plan)
  - *United Artists Theaters v. Walton,* 315 F.3d 217, 228 (3d Cir. 2003) (same, striking indemnification provision)
  - *In re PWS Holding Corp.,* 228 F.3d 224, 236 (3d Cir. 2000) (same, striking releases)

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Rumblings in Fifth and Tenth Circuits

- Following its highwater mark, Circuit Courts have begun to carve back mootness
  - *In re Pacific Lumber,* 584 F.3d 229, 322 (5th Cir 2010)

    Court allowed appeal with respect to an unpaid administrative expense claim that would have to be funded by third party equity investor under the plan and excised plan releases; "so long as there is the possibility of 'fractional recovery,' [appellants] need not suffer the mootness of their claims."
  - *In re Paige,* 584 F.3d 1327 (10th Cir. 2009)

    Court set aside consummated plan under which asset had been sold and creditors paid from the proceeds, apparently because the Court concluded that the assets would be sold to one of two creditors who were both before the Court, the creditors would be paid in either event, and, taking a "quick look" at the merits, concluded the appeal raised substantial questions of misconduct on the part of the trustee and the successful plan proponent

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Third Circuit vs. Third Circuit

- *In re One2One*, 728 F.3d 314 (3d Cir. 2013)
  - 17 unsecured creditors (excl. objecting $9 MM creditor) totaled $1.3 MM
  - A single secured creditor was owed $100,000
  - Plan provided for sponsor to make $200,000 contribution for 100% of the new equity and pay unsecured creditors $1.25 MM over seven years (totaling ~12.5%); release of preference claims; third party releases
  - Appellant sought stay at every level, plan was consummated
  - District Court dismissed appeal as equitably moot
  - Appellant argued mootness was unconstitutional and contrary to the Code
  - Third Circuit reversed District Court, emphasizing that mootness intended to apply to "complex" reorganizations, particularly involving public securities, and this was a simple reorganization that could easily be set aside without affecting third party interests

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One2One Concurrence

- Judge Krause questioned equitable mootness, calling it

  unmanageable (noting the Court had reversed district court decisions on mootness seven times since *Continental*),

  unconstitutional (by preventing Article III court supervision over bankruptcy court decisions),

  unauthorized (in lacking statutory basis) and

  lacking in efficacy (the duration and extent of appeals over mootness show it does not promote finality, but uncertainty, delay and opportunism, and prevents the healthy development of uniformity of appellate case law on important confirmation issues)

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. . . One2One Concurrence

- Judge Krause urged en banc review to replace mootness with doctrine that examines the merits first, then remedies afterwards or if not, revise mootness to
  - Place greater weight on appellants' attempts to obtain a stay
  - Clarify what constitutes harm to third parties, depending on whether they had the opportunity to participate in the bankruptcy case, and be less solicitous of those who act opportunistically or advocate unlawful plan provisions
  - Change standard of review to de novo
  - Incorporate a quick look at the merits to determine whether the appeal has merit

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Tribune

- *In re Tribune Media Co.,* 799 F. 3d 272 (3d Cir. 2015)
  - Decided one month after *One2One*
  - Involved complex chapter 11 case with public securities and a $370 MM settlement of fraudulent transfer litigation based on pre-petition LBO
  - Holder of $2 billion in bonds appealed confirmation and sought a stay
  - Bankruptcy court conditioned stay on $1.5 billion bond, which bondholder did not post, objecting to any bond as a condition of a stay
  - A second appeal challenged the application of a subordination agreement between two creditor classes

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. . . *Tribune* Decision

- Third Circuit affirmed district court's dismissal of appeal as moot
  - Plan equity investor's third-party reliance is most salient
  - Weighs against mootness if funds can be recovered from third parties without the plan falling apart, or reallocated between classes
  - Bondholder appeal moot because it would upset the settlement at the heart of the plan, and diminish the value of the new equity investment
  - Also moot because bondholder declined to seek a reduction of the bond, arguing instead that no bond should be required
  - Second appeal not moot because there are practical ways to disgorge distributions and modify plan waterfall to implement any change; also, minor ($30 MM issue in $7.5 billion case)
  - Disgorgement is not inequitable where a windfall is being returned
  - Bondholder petitioned for certiorari, which was denied

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. . . *Tribune* Concurrence

- Judge Ambro specially concurred in his own majority opinion to respond to Judge Krause's concurrence in *One2One*
  - Mootness does not violate Article III because the supervision of the bankruptcy courts by the Article III courts is a concern that Congress not redirect adjudication away from Article III courts, a concern that equitable mootness does not implicate
  - Express statutory authority is not required for equitable mootness because it is an equitable doctrine that is not contrary to the Code and is similar to an injunction in balancing harms
  - Mootness should be rare and the courts of appeals need to police it
  - Eliminating equitable mootness would give any dissenting creditor with a plausible argument the ability to hold up plan consummation until appeals exhausted or creditor bought off
  - Finally, in appropriate cases, no problem with concurrently reviewing the merits along with mootness, but would not crystalize it as a rule

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Meanwhile, in the Ninth Circuit…..

- Two recent decisions question the justifiable reliance of third-party investors
  - *In re Transwest Resort Properties, 801 F.3d 1161 (9th Cir. 2015)*
    - Lender had $300 MM claims secured by $92 MM property
    - Lender elected 1111(b) and appealed confirmation because plan permitted debtor to sell the property subject to the restructured loan between the 5th and 15th year after confirmation
    - Ninth Circuit reversed dismissal of the appeal as moot, holding that third-party investor's reliance on plan confirmation was not sufficient because the investor participated in the preparation of the confirmation order and was not "innocent"
    - Dissenting judge said this would chill bankruptcy investments

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. . . Ninth Circuit

- *In re Sunnyslope Housing,* 818 F.3d 937, 944 (9th Cir. 2016)*
  - Secured creditor's appeal of consummated plan based on value of the property not moot despite funding for plan of reorganization by third party investor who provided funds from a 1031 exchange
  - Investor was "sophisticated," "was intimately involved in the development of the plan," and "decided on their own to obtain funds for this investment via an exchange transaction that posed potential tax risks if something went wrong."

- **Vacated by, Rehearing, en banc, granted by*, 838 F.3d 975 (th Cir 2016), *aff'd*, 869 F.3d 637 (9th Cir. 2017) (not addressing mootness).

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Have Courts Cut Back Mootness?

- It seems that the doctrine has been limited, is that true, or are parties seeking to apply it more broadly than before?
- If it is being cut back, why?
  - Are plans more complex and determining more issues than before?
  - Are appellate courts reacting to mootness differently?
  - Are plan proponents building components into plans to achieve mootness?

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Non-Plan Equitable Mootness?

- Courts are split on the application of equitable mootness outside the chapter 11 plan context
  - Third Circuit has expressly limited to plans. *In re LCI Holdings, Co.,* 802 F.3d 547 (3d Cir. 2015) (noting prior Circuit authority limiting equitable mootness to plans, and declining to apply it to sale/settlement transaction)

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. . . Non-Plan Mootness

- Other Circuits have been more expansive
  - *In re BGI, Inc.,* 772 F.3d 102, 109 n.13 (2d Cir. 2014) (Chapter 11 liquidation)
  - *In re Nica Holdings, Inc.,* 810 F.3d 781 (11th Cir. 2015) (assuming, without deciding, that a settlement of claims in a chapter 7 could be subject to equitable mootness, but holding that they were not moot)
  - *In Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716 (S. D. Fla. 2010) (cash collateral order)
  - *In re City of Detroit Michigan*, 838 F.3d 792 (6th Cir. 2016)(equitable mootness applies to Chapter 9 plan)

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Summary

- Together, erosions of mootness add up to the following:
  - Equitable plan mootness as a *reliable doctrine* applies to complex cases, and to the issues that either go to the core of those cases or affect public securities or third-party investors' rights or interests
  - For an issue to be moot there must be specific evidence tying the resolution of the issue to other, more central, economic issues or reliance interests
  - Failure of diligence on the appellant's part will weigh in favor of mootness
  - Because appellate courts are not fact-finders, careful thought should be given to developing the evidentiary record for mootness at confirmation, including consequences of reversal

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What Happens if a Plan Isn't Moot?

- What do you do if a plan or sale isn't moot?
  - Can distributions be recovered/transactions set aside?
  - Can value be reallocated?
  - Can the purchaser's rights be affected?
  - What happens to liens – can they be reinstated?
  - What happens when a plan is remanded? Is the debtor back in chapter 11?

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