No. 08–40746

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Bank of New York Mellon Trust Company, N.A., as Indenture Trustee for the Timber Notes; Angelo Gordon & Co. LP, Aurelius Capital Management, LP, and Davidson Kempner Capital Management LLC; Scotia Pacific Company LLC; CSG Investments, Inc.; Scotia Redwood Foundation, Inc. — Appellants,

v.

Official Unsecured Creditors' Committee; Marathon Structured Finance Fund L.P.; Mendocino Redwood Company LLC; The Pacific Lumber Company; United States of America; California State Agencies — Appellees.

Direct Appeal from the United States Bankruptcy Court
for the Southern District of Texas, Corpus Christi Division
USBC No. 07-20027

APPELLANTS' PETITION FOR PANEL REHEARING

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ARGUMENT AND AUTHORITIES

The Panel Should Resolve the Noteholders' Contention That The MRC/Marathon Plan Violated The Absolute Priority Rule Because It Diverted $28 Million To Unsecured Creditors From The Price Paid For Scopac's Encumbered Assets Before The Creditors Secured By Those Assets Were Fully Repaid

At pages 10-11 of the slip opinion, the panel listed the issues the Indenture Trustee raised on appeal. The very first argument listed was that the MRC/Marathon Plan "violates the absolute priority rule by paying junior Palco and Scopac creditors with the Noteholders' collateral." Yet, with respect, the panel did not actually address that issue in its opinion. *Related* issues—including whether the plan violated 11 U.S.C. § 1129(b)(2)(A) and whether it involved improper *de facto* substantive consolidation, improper gerrymandering of classes, or improper discrimination—were addressed. Slip op. 20-33 (holding that the plan did not violate (b)(2)(A)), 34-35 (rejecting *de facto* substantive-consolidation argument), 37-39 (declining to reach gerrymandering argument because of equitable mootness), 39 (declining to reach discrimination argument for same reason). But Appellants *also* raised the independent argument that the plan violated uncodified components of the statutory requirement that a plan be "fair and equitable" for it to be confirmed over the objection of a non-consenting class. Appellants' Br. 1, 11-12, 20, 23-28; Appellants' Reply Br. 16-21; see, *e.g.*, Kenneth N. Klee, *Cram*

Down II, 64 AM. BANKR. L.J. 229, 230, 234 (1990) (discussing uncodified aspects of absolute priority rule). Nowhere did the panel analyze that contention.

Virtually all of Scopac's assets secured its $740 million debt to the Noteholders. Under the MRC/Marathon Plan, "Newco" received $580 million from MRC and Marathon, and used those funds to buy Scopac's assets free and clear of their liens. This Court recognized that transaction for what it was: a sale of Scopac's assets. Slip op. 24-25. ("[T]he bankruptcy court held that . . . the reorganization plan constitutes a 'transfer' rather than a 'sale' of assets. . . . We agree with the Noteholders that this ruling was wrong. . . . That the transaction is complex does not fundamentally alter that it involved a 'sale' of the Noteholders' collateral. . . . Here, a sale occurred.") Not all of the proceeds of that sale were distributed to Scopac's *secured* creditors, however, because the Plan paid $28 million of those funds to Scopac's and Palco's *unsecured* creditors. That diversion of funds violated the absolute priority rule, which is an important part of the requirement that any reorganization plan that is crammed down on a dissenting class of creditors must fully pay senior creditors before junior ones in order to be "fair and equitable" under 11 U.S.C. § 1129(b)(2).

The panel's opinion did not apply the absolute priority rule to those circumstances. Instead, the opinion examined only Section 1129(b)(2)(A)'s list of "alternative minimum standards," slip op. 26; see also *In re Sandy Ridge Dev.*

Corp., 881 F.2d 1346, 1352 (5th Cir. 1989) (referring to the Section's "minimal standards"), and held that a plan providing a dissenting secured creditor with the indubitable equivalent of the judicial valuation of its claim *can* be "fair and equitable" despite denying a secured creditor the right to credit bid. See slip op. 22-33. Appellants respectfully disagree with that conclusion, but do not seek rehearing on that issue. Even if the MRC/Marathon Plan met Section 1129(b)(2)(A)'s codified minimum requirements, those are necessary, but sometimes insufficient, conditions for fairness and equity.

In this case, the panel's opinion did not address why unsecured creditors received a distribution; indeed, those payments cannot be squared with the absolute priority rule. Appellants respectfully request that the panel correct that oversight. The Noteholders are entitled to effective relief, which is available through either a cash payment or reimposition of their liens to the extent that the MRC/Marathon Plan violated the absolute priority rule by diverting the proceeds of Appellants' collateral to junior creditors.

A. The Absolute Priority Rule Requires That Secured Creditors Receive *All* Of The Price Paid For Scopac's Assets Before *Any* Distribution To Unsecured Creditors, Because Virtually *All* Of Scopac's Assets Secured Its Debt

Scopac did not enter bankruptcy as a plain-vanilla debtor that owned a diverse portfolio of both encumbered and unencumbered assets. To the contrary, Scopac was a special purpose entity ("SPE") created *solely* to (1) take ownership

of Palco's most valuable assets—principally the Timberlands, and (2) encumber essentially *all* of those assets to obtain secured financing. When Scopac issued and sold the $867.2 million in notes that are held by the Noteholders, it secured those notes with liens on virtually *every asset* it had. See slip op. 4.

In a plain-vanilla case, the segregation and valuation of encumbered versus unencumbered assets can be critical to apportioning recovery among secured and unsecured creditors; creditors' relative recovery depends upon which of the debtor's assets served as collateral for secured debt and which remain available to repay general creditors. Not so at Scopac. It is *undisputed* that virtually all of its assets were pledged to the Noteholders and Bank of America as collateral. If things went south for Scopac, its unsecured creditors' *only* hope for *any* recovery rested in the possibility that the company's nearly-fully-encumbered portfolio of assets might turn out to be worth more than the debt it secured. That hope did not materialize at confirmation. Yet somehow Scopac's and Palco's unsecured creditors received $28 million under the MRC/Marathon Plan. Those payments simply do not comport with the dictates of the absolute priority rule—even assuming the panel correctly held that the Noteholders received the "indubitable equivalent" of their secured claim under Section 1129(b)(2)(A)(iii).

MRC and Marathon contributed $580 million to Newco, which in turn used those funds to pay for Scopac's assets, released from their existing liens.[1] That was a sale, slip op. 24-25, and creditors holding debt secured by those assets had a security interest in the proceeds of that sale, see 11 U.S.C. § 1129(b)(2)(A)(ii); U.C.C. § 9-315.

The Plan distributed the first $37.6 million of those proceeds to Bank of America in full repayment for a debt that was also secured by liens on substantially all of Scopac's assets and enjoyed a higher priority than the Noteholders' claim. Excerpt H, Attachment 1, Dkt-3300, § 4.5. The Noteholders were Scopac's only other secured creditor, and under the absolute priority rule the MRC/Marathon Plan should have paid the Noteholders the remaining $542.4 million of Newco's purchase price for Scopac's assets. All of those assets were subject to the Noteholders' liens, and the Noteholders were undersecured at confirmation. In other words, after accounting for Scopac's secured debt, the company's assets—whatever their price—had *no residual value* available for distribution to unsecured

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[1] As explained in greater detail in the Appellants' Opening Brief (at 10-12), Palco—Scopac's parent company—had separate assets that were fully encumbered by liens held by Marathon, which was undersecured. Marathon's Palco liens were treated separately pursuant to the MRC/Marathon Plan. See Excerpt H, Attachment 1, Dkt-3300, ¶¶ 4.3, 4.4. The Plan transferred most of Palco's assets—principally the Town of Scotia—to a new entity called "Townco," and transferred a sawmill and that mill's working capital to Newco. In full satisfaction for the release of its liens on those assets, Marathon received a 100% ownership interest in Townco, a 15% ownership interest in Newco, and a promissory note in the amount of (and secured solely by) the sawmill's working capital. *Ibid.*

creditors. The entire purchase price *necessarily* had to flow to secured creditors because there was nothing left for unsecured creditors.

That didn't happen here. The MRC/Marathon Plan paid the Noteholders only $513.6 million—not $542.4 million—in exchange for all of Scopac's assets stripped of the Noteholders' liens. The Plan diverted the approximately $28 million remainder of Newco's purchase price to Scopac's and Palco's *unsecured* creditors. That distribution amounted to little more than a forced "gift" from higher-priority secured creditors to lower-priority unsecured creditors of a portion of the proceeds from Scopac's encumbered assets—proceeds to which their security interest had transferred. That is precisely the sort of unfair and inequitable result that the absolute priority rule prohibits.

To "cram down" a Chapter 11 reorganization plan against a dissenting class of creditors, the plan must be "fair and equitable" with respect to any dissenting classes of claims. 11 U.S.C. §1129(b)(2). The term "fair and equitable" is a term of art that encompasses, among other time-honored equitable principles of bankruptcy, the absolute priority rule. "[I]t is clear that the absolute priority rule requires senior classes to be paid in full or have all reorganization value allocated to them before junior classes can participate." 7 LAWRENCE P. KING *ET AL.*, COLLIER ON BANKRUPTCY ¶ 1129.04[4][b], at 1129-104 to -105 (15th ed. Rev. 2009).

Although Section 1129(b)(2)(A) provides certain "alternative minimum standards" (slip op. 26) that the "fair and equitable" requirement "includes," they are only the "minimal standards that a plan must meet" and "simple technical compliance with th[ose] requirements . . . does not assure that the plan is fair and equitable." *In re Sandy Ridge Dev. Corp.*, 881 F.2d at 1352; see also *In re Briscoe Enters.*, 994 F.2d 1160, 1168 (5th Cir. 1993) ("§ 1129(b) requires that a cramdown be fair and equitable. The statute provides three alternative *minimum requirements* for the plan to be considered fair and equitable with regard to secured creditors." (emphasis added)). Significant applications of the absolute priority rule remain "uncodified" by those specific standards of fairness and equity. See generally Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990) (cataloguing myriad uncodified aspects of the absolute priority rule). The determination, to choose a relevant example, that a reorganization plan provides a dissenting secured creditor with the "indubitable equivalent" of the judicially determined value of his collateral does not excuse a court from weighing a plan's overall fairness and equity "in the context of the rights of the creditors under state law and the particular facts and circumstances" of the case, *In re D&F Const., Inc.*, 865 F.2d 673, 675 (5th Cir. 1989)—including the need to conclude that the plan complies with the absolute priority rule.

Here the relevant "context" is that the Noteholders held liens on substantially all of the debtor's assets. Bankruptcy courts have correctly recognized that, in those circumstances, the absolute priority rule requires that a plan pay a secured creditor's *entire debt* before any unsecured creditor participates in the reorganization, because the debtor has no unencumbered value to be distributed otherwise. As one bankruptcy court has put it:

> Under the absolute priority rule, when the issue is cramdown under § 1129(b)(2) and where the value of the estate's sole asset is going forward in the future and there is an objecting secured lender, any plan of reorganization either must pay, in present value terms, *the entire debt owed to the secured lender* or it has to leave *nothing* with junior or residual claimants.

In re Lakeside Global II, Ltd., 116 B.R. 499, 511 (Bankr. S.D. Tex. 1989) (double emphasis added).

But that did not happen here. A portion of the value that Newco paid for its purchase of Scopac's assets was diverted to creditors whose claims were unsecured, in clear violation of the absolute priority rule. As their only explanation for why this happened, MRC and Marathon could suggest only that Newco "paid more than the value of Scopac's assets"—apparently out of some counterintuitive desire to donate (up front) the value of various "synergies" that MRC and Marathon expected to experience from the deal. Appellees' Br. 32-33. That is unlikely, to say the least, but more importantly it misses the point. See Appellants' Reply Br. 20-21. As the absolute priority rule applies here, *whatever* MRC and

Marathon decided to pay for Scopac's assets, for *whatever* reason, the only things they paid for were assets encumbered by the Noteholders' liens. In exchange for that payment, the MRC/Marathon Plan directed that those liens be stripped from the Noteholders' collateral. In those circumstances, the Noteholders were entitled to *all* of the proceeds of the sale of their collateral. In short, there was no value in Scopac from which to pay unsecured creditors, and paying them anyway violated the absolute priority rule.

B. The Panel's Opinion Does Not Address This Critical Application Of The Absolute Priority Rule; Without Assurances That Lenders Who Are Secured By An SPE's Entire Asset Portfolio Will Receive All Proceeds From Any Sale Of Those Assets In Bankruptcy, The Costs of Capital Will Inevitably Rise

The panel's opinion did not address the Noteholders' application of the absolute priority rule, and did not explain how $28 million of the cash that Newco paid for Scopac's assets could have been distributed to *unsecured* creditors without violating the absolute priority rule. Instead, the panel's opinion examined the Noteholders' arguments as though they called for review only of whether the bankruptcy court's valuation of Scopac's collateral was clearly erroneous, and of whether the MRC/Marathon Plan's payment of the amount of that valuation ensured that the MRC/Marathon Plan met the minimum requirements that a plan be "fair and equitable" set forth in Section 1129(b)(2)(A). See slip op. 23-33.

The panel opened the relevant discussion by recognizing that the absolute priority rule applies to this case, see slip op. 22-23, and it concluded with the assertion that the rule was not violated here, see *id.* at 33. Between those bookends, however, the panel focused *solely* on developing two conclusions that—although they reach other aspects of the appeal—did not address the MRC/Marathon Plan's violation of the aspects of the absolute priority rule not codified in 11 U.S.C. § 1129(b)(2)(A). In particular, the panel concluded (1) that the bankruptcy court did not make a clearly erroneous finding when it valued Scopac's assets at $513.6 million—$510 million for the Timberlands (slip op. 31-33) and $3.6 million for the non-Timberlands collateral (*id.* at 33 n.24), and (2) that a cash payment for the amount of that judicial valuation sufficiently satisfied one of the "minimum standards" (*id.* at 26) of a "fair and equitable" reorganization plan by providing the Noteholders with the indubitable equivalent of their claims (see *id.* at 23-30).

Neither conclusion fully answers the absolute priority issue raised by this appeal. The panel's discussion of indubitable equivalence and judicial valuation leaves unanswered a critical question: How did unsecured creditors get $28 million if the Noteholders held liens on all Scopac's assets and were not fully repaid on Scopac's secured debt? Where did that money come from, if not from the proceeds of Scopac's asset sales to Newco? The panel acknowledged that

"[e]ven a plan compliant with these alternative minimum standards is not necessarily fair and equitable," slip op. 26, and so it was necessary for the panel to proceed to address the MRC/Marathon Plan's payment of *unsecured* creditors out of the value that plan proponents paid for Scopac's fully encumbered assets. The opinion did not do so.

If the panel's opinion meant to suggest that the "fair and equitable" requirement is narrowly satisfied by the mere showing that a secured creditor received the indubitable equivalent of a judicial valuation of its collateral, even though the same collateral actually commanded a higher purchase price, such an analysis would be difficult to square with the panel's recognition that "[i]ndubitable equivalent is . . . no less demanding a standard than its companions [under Section 1129(b)(2)(A)]." Slip op. 28. If the two "companions" in Section 1129(b)(2)(A)(ii) and (iii) are equally "demanding" of the debtor's estate and protective of the secured creditor, the MRC/Marathon Plan cannot provide the Noteholders with only $513.6 million while selling the collateral for net proceeds of $542.4 million (after payment to Scopac's higher priority secured creditor, Bank of America). The numbers simply don't add up, and the distribution to unsecured creditors of the difference from Newco's payments and the judicial valuation of the collateral was contrary to the absolute priority rule and thus not fair and equitable.

In many respects, the panel's oversight in not fully analyzing the absolute priority violation in this case can be gleaned from its following statement:

> It is only because [the Noteholders] perceive a valuation shortfall that they contend more of the purchase price of the assets should have been paid for their collateral and was improperly used to pay junior creditors.

Slip op. 23. The key to understanding why the MRC/Marathon Plan violated the absolute priority rule, however, is that "the assets" at issue *are the same as* "their collateral." That is, this is not a "plain-vanilla" dispute over whether "more of the purchase price" should have been attributed to the Noteholders' encumbered assets versus other sources of the debtor's value; *the principle is that every penny of that purchase price necessarily derived from the encumbered assets and thereby belonged to the Noteholders under the absolute priority rule.* Similarly, it is not the case that "the Noteholders would not complain" if the MRC/Marathon Plan paid them an amount that "aligned with their valuation." *Ibid.* Rather, so long as the Noteholders were not repaid the amount of their entire debt (approximately $740 million), *any* amount that the MRC/Marathon Plan diverted from Newco's purchase price to unsecured creditors would violate the absolute priority rule—*even if the Plan paid the Noteholders the full amount that they believed Scopac's assets were worth at confirmation.*

In another portion of its opinion, the panel correctly highlighted the dangers that substantive consolidation poses to SPE financing. See slip op. 35 n.25. But

violations of the absolute priority rule are just as anathematic to the vitality of these important financial instruments; if junior creditors are allowed to reap some of the proceeds from the sale of *entirely encumbered assets* before an SPE's secured creditors are repaid in full, then "investors will grow less confident in the value of the collateral securing their loans; the practice of securitization . . . will become less useful; and the cost of capital will increase." *Ibid.*

C. This Court Can Provide The Noteholders With Effective Relief To Remedy The MRC/Marathon Plan's Violation Of The Absolute Priority Rule

Even if so-called "equitable mootness" can operate to foreclose review of a secured creditor's appeal that it was stripped of its property interest in collateral though the improper confirmation of a reorganization plan (but see Appellants' Pet. for Reh'g *En Banc* (filed Oct. 13, 2009)), the panel's opinion nonetheless makes it clear that the Noteholders' $28 million claim that the MRC/Marathon Plan violated the absolute priority rule is not equitably moot. A claim of that magnitude "would seem not to imperil a reorganization involving hundreds of millions of dollars." Slip op. 35-36 (reversing and remanding the confirmation order's treatment of an $11.1 million inter-company administrative expense claim). The bankruptcy court could award effective relief in the amount of the Noteholders' claim either through "an appropriate lien in the Noteholders' favor or

a cash payment." *Ibid.*; see also *In re Sun Country Dev., Inc.*, 764 F.2d 406, 407 n.1 (5th Cir. 1985).

CONCLUSION

For the foregoing reasons, this panel should grant the petition for panel rehearing so that it can reverse the relevant portion of the Confirmation Order and remand to the bankruptcy court for determination of a cash payment or lien reimposition sufficient to remedy the MRC/Marathon Plan's violation of the absolute priority rule.

Dated: October 12, 2009

Respectfully submitted,

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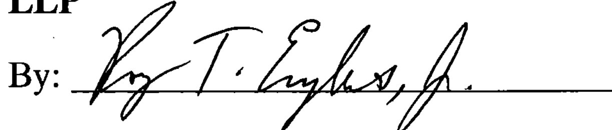
By: 

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In compliance with FED. R. APP. P. 31 and 5TH CIR. R. 31, I certify that, on October 13, 2009, pursuant to a written agreement between the parties, the Appellants' Brief was served on the counsel listed below via electronic mail.

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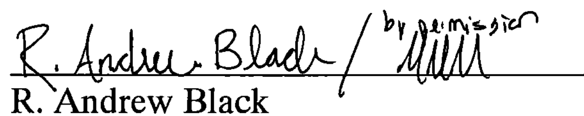

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