IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
CORPUS CHRISTI DIVISION

In Re:	§	
	§	
Scotia Development LLC, *et al.*,	§	**Civil Action: 08-259**
	§	
Debtor-In-Possession.	§	**Bankruptcy Case: 07-20027**
	§	

APPELLANTS' REPLY BRIEF

FULBRIGHT & JAWORSKI L.L.P.

Toby L. Gerber (SBTX 07813700)
(S.D. Tex.: 21903)
Louis R. Strubeck, Jr. (SBTX 12425600)
(S.D. Tex.: 15416)
O. Rey Rodriguez (SBTX 00791557)
(S.D. Tex.: 19068)
2200 Ross Avenue, Suite 2800
Dallas, Texas 75201-2784
Telephone: (214) 855-8000
Facsimile: (214) 855-8200

FULBRIGHT & JAWORSKI L.L.P.

Zack A. Clement (SBTX 04361550)
(S.D. Tex.: 06445)
William Greendyke (SBTX 08390450)
(S.D. Tex.: 576573)
R. Andrew Black (SBTX 02375110)
(S.D. Tex.: 09040)
Jason L. Boland (SBTX 24040542)
(S.D. Tex.: 37238)
Mark Worden (SBTX 24042194)
(S.D. Tex.: 36997)
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
Telephone: (713) 651-5151
Facsimile: (713) 651-5246

COUNSEL FOR APPELLANT INDENTURE TRUSTEE

STUTMAN, TREISTER & GLATT P.C.

Isaac M. Pachulski (Cal. 62337) (admitted *pro hac vice*)
Jeffrey H. Davidson (Cal. 73980) (admitted *pro hac vice*)
Eric D. Winston (Cal. 202407) (admitted *pro hac vice*)
1901 Avenue of the Stars, 12th Floor
Los Angeles, California 90067
Telephone: (310) 228-5600
Facsimile: (310) 228-5788

COUNSEL FOR APPELLANTS ANGELO, GORDON & CO., L.P., AURELIUS CAPITAL MANAGEMENT, LP, AND DAVIDSON KEMPNER CAPITAL MANAGEMENT LLC

AKIN GUMP STRAUSS HAUER & FELD LLP

Murry Cohen (SBTX 04508500)
(S.D. Tex.: 570348)
1111 Louisiana Street, 44th Floor
Houston, Texas 77002-5200
Telephone: (713) 220-5800
Facsimile: (713) 236-0822

AKIN GUMP STRAUSS HAUER & FELD LLP

Charles R. Gibbs (SBTX 07846300)
(S.D. Tex.: 00177)
David F. Staber (SBTX 18986950)
(S.D. Tex.: 437693)
J. Carl Cecere (SBTX 24050397)
(S.D. Tex.: 827732)
1700 Pacific Avenue, Suite 4100
Dallas, Texas 75201
Telephone: (214) 969-2800
Facsimile: (214) 969-4343

COUNSEL FOR APPELLANTS CSG INVESTMENTS, INC. AND SCOTIA REDWOOD FOUNDATION, INC.

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PRELIMINARY STATEMENT

The Appellees seek to characterize the central dispute here—whether the Timberlands declined in value during the pendency of Scopac's chapter 11 case—as a garden variety "clearly erroneous" case. It is not. It was undisputed below that, during the course of the bankruptcy case, there was a dramatic deterioration in the market for the primary product produced by the Timberlands (redwood logs) because of the subprime and residential housing crisis. *See* Appellant 389 at pp. 2-3. There was no evidence to the contrary, nor could there have been. No other corner of the country's economy escaped the massive impact of this economic calamity; and no asset can retain its value when the market for its product goes into a tailspin. Nevertheless, the Bankruptcy Court found that the Timberlands retained every cent of their value throughout this economic decline—even as it relied on the decline in the Timberlands' value to justify confirmation of the bankruptcy plan. The Bankruptcy Court's finding is implausible, and even the "clearly erroneous" standard does not require a reviewing court to defer to the trial court's adoption of a story "so internally inconsistent or implausible on its face that a reasonable fact finder would not credit it." *Anderson v. City of Bessemer City*, 470 U.S. 564, 574-75 (1985) ("Where such factors are present, the court of appeals may well find clear error even in a finding purportedly based on a credibility determination . . . ."); *see also Savic v. United States*, 918 F.2d 696, 700 (7th Cir. 1990). This is precisely such a case.

Moreover, the *sole* basis for the Bankruptcy Court's factual findings on this point—the testimony of Mr. La Mont—consisted, in substance, of legally impermissible hindsight thinly veiled by vague generalities. Moreover, that testimony was, among other things, inconsistent both with views that Mr. La Mont *himself* expressed before the Appellees hired him to be a litigation witness as well as with an earlier position of MRC's CEO (when he was not preparing to testify) regarding the direction of discount rates.

As a legal matter, the Appellees' attempt to defend the Bankruptcy Court's theory that the relevant value of the Timberlands as of the Petition Date was really their foreclosure value—not their fair market value—contradicts the approach that the Appellees *themselves* took in presenting valuation testimony at the 507(b) Hearing; does violence to the statutory text of section 507(b); and is inconsistent with clear authority as to the manner in which collateral that is being used by a debtor must be valued as of the Petition Date. The Appellees' last-ditch argument that any decline in the value of the Timberlands was not shown to have arisen from the Debtors' "use" of the Timberlands is contrary to the unqualified terms of the cash collateral orders, is contrary to the law, and, not surprisingly, was not even adopted by the Bankruptcy Court.

The Bankruptcy Court's ruling that there was no diminution in the Cash Collateral involves no disputed issue of fact; the ruling was wrong as a matter of law. It was undisputed below that the Indenture Trustee's Cash Collateral was depleted by more than $18 million by Scopac's payment of fees to Scopac's professionals and those employed by the Creditors' Committee. Appellant 449 at pp. 3-4. These were not ordinary Scopac operating expenses; these fees were non-revenue producing. Contrary to the requirements of its own cash collateral orders, the Bankruptcy Court refused to compensate the Indenture Trustee for this diminution.

The Appellees attempt (p. 31) to defend that ruling by claiming that the Bankruptcy Court protected the Indenture Trustee "By Giving It The Value Of That Collateral *As Of The Petition Date*, Less Proper Deductions." This theory ignores the fact that the cash collateral orders expressly promised the Indenture Trustee an administrative expense claim to compensate for any "post-petition diminution of its interest in . . . Cash Collateral," *which included Cash*

Collateral generated after the Petition Date.[1] The Bankruptcy Court disregarded its own orders and erred as a matter of law in limiting its focus to the value of the Petition Date Cash Collateral, and disregarding collateral generated thereafter—which it had also promised to protect.

Meanwhile, the Bankruptcy Court's $8.9 million deduction from the Petition Date Cash Collateral for fees paid to the Indenture Trustee's professionals over the course of the bankruptcy proceedings was not a "proper deduction." Because those payments were made from Cash Collateral generated by the Timberlands post-petition, the Bankruptcy Court's deduction of this amount from the Petition Date Collateral represented an improper double deduction.

ARGUMENT

I. Based On The Uncontradicted Valuation Evidence Available As Of The Petition Date, The Timberlands Declined In Value During The Course Of The Bankruptcy Proceedings.

The primary drivers of value for the Timberlands consist of: (i) harvest rates (which determine the amount of product available to sell and generate revenues); (ii) log prices (which directly affect gross revenues, net revenues, and cash flow); and (iii) discount rates (which affect the present value of the projected future cash flows). Appellant 211 at p. 359:14-16. The uncontradicted evidence established that, based on the information available substantially contemporaneously with the Petition Date: (i) the harvest rates assumed for purposes of any valuation as of January 2007 would be substantially higher than those used by MRC/Marathon's expert, Mr. La Mont, for purposes of his opinion of value at the Confirmation Hearing 16 months later; (ii) projected log prices as of January 2007 would be substantially higher than those projected as of the Confirmation Hearing; and (iii) the discount rate as of the Petition Date would be no higher, and would likely be lower, than that used as of the Confirmation Hearing. Thus,

[1] The Bankruptcy Court's cash collateral orders defined the "Cash Collateral" that was protected broadly as "the proceeds and product of the Prepetition Collateral . . . ." *See, e.g.,* Appellant 6 at ¶ 14.

the numbers resulting from the operative information as of the Petition Date cannot be squared with the Bankruptcy Court's finding that the value of the Timberlands did not decline during the next 16 months. Indeed, it was only through an improper resort to "hindsight" evidence that one could arrive at the conclusion reached by the Bankruptcy Court.

A. The Bankruptcy Court Improperly Relied On Hindsight Evidence In Valuing The Timberlands.

The Appellees claim (pp. 29-30) that "nothing forbids the use of subsequent information [i.e., hindsight] where it is necessary." The reality, however, is more complex. The use of hindsight evidence must be approached with caution when preparing retrospective valuations. 7 LAWRENCE P. KING, COLLIER ON BANKRUPTCY, ¶ 1129.06[2][a] (15th ed. Rev. 2008). A court should take care not to use evidence that was "neither anticipated nor foreseeable" at the relevant time. *WRT Creditors Liquidation Trust v. WRT Bankruptcy Litigation Master File (In re WRT Energy Corp.)*, 282 B.R. 343, 383 (Bankr. W.D. La. 2001). Where significant market events have subsequently occurred that could not have been foreseen as of the valuation date, evidence subsequent to that date should not be used. *See Briarcliff v. FDIC*, 801 F.2d 631 (3d Cir. 1986) (refusing to use after-acquired interest rates to determine value of an option for purposes of evaluating whether debtor was insolvent); *see also In re Longview Aluminum*, L.L.C., No. 03 B 12184, *et al.*, 2005 WL 3021173, at *7 (Bankr. N.D. Ill. July 14, 2005) (rejecting use of unforeseeable price depression to determine profitability of a business). Further, where hindsight evidence is used, it should be done openly, explicitly, and carefully to insure that no impermissible uses of hindsight somehow creep into the analysis.

The valuation by the Indenture Trustee's expert, James Fleming, provides a good example of the permissible, limited use of hindsight evidence. In determining one element of the Petition Date value—log prices—Fleming used comparable sales during the May 2006 to May

2007 period, although some of these sales occurred after the Petition Date. Appellant 211 at pp. 170:13 – 171:24 (discussing prices of young-growth redwoods). He did so, however, only because timber sales tended to be annually cyclical following demand for construction materials, whereby prices are lowest in the Fall and highest in the Spring. Appellant 211 at pp. 170:17-24, 172:14-17, 176:7-12, 204:22 – 205:1, and 208:13-22. Using only the previous Fall's data in determining log prices for a mid-Winter Petition Date appraisal would artificially depress value because, by January, prices would have increased toward their traditional Spring highpoint. Fleming noted that there were no intervening market events that would make the use of the Spring 2007 data in any way misleading. Appellant 221 at p. 208:1-6. In fact, given the cyclical nature of timber prices, Fleming's analysis would have been misleading if he had not included this evidence. Appellant 211 at p. 208:1-6 (noting that prices were relatively stable throughout the period). While Mr. Fleming was open to using hindsight evidence on a very limited basis, he offered a cogent explanation of his methodology. In contrast, Appellees' expert, Mr. La Mont, relied upon hindsight without providing any justification or explanation, resulting in a fundamental and fatal flaw in his opinion of the Petition Date value.

1. Mr. La Mont Improperly Relied On Hindsight With Respect To Discount Rates.

For his valuation of the Timberlands, La Mont used a 6% discount as of the Confirmation Date, and used a 7% discount rate as of the Petition Date. Appellant 276 at ¶¶ 14-16. He then added 1% to both rates, to reflect the risks inherent in the California regulatory market for Timber. *Id*. at ¶¶ 15-16. As La Mont testified, this supposed change in discount rate was the "primary" driver for his opinion that the Timberlands did not decrease in value, because, all else being equal, a falling discount rate suggests an increase in the value of an asset. Appellant 211 at p. 359:11-21.

As explained in our opening brief, Mr. La Mont improperly relied on hindsight in calculating his Petition Date discount rate when he considered certain "PowerPoint" presentations created by someone else *over one year after* the Petition Date. *See* Brief at pp. 32-37. Appellees argue (p. 28) that "La Mont made his own analysis showing a decline in the discount rate based on data from 2006 and early 2007, and merely confirmed that opinion by speaking to other experts and reviewing the PowerPoint presentations." As described in the Appellants' Brief (p. 12), however, the comparable sales utilized by Mr. La Mont illustrated that the discount rate for timberlands had already begun to fall before the Petition Date, *and that the most contemporaneous sale utilized a discount rate of 6% as compared to the 7% discount rate ultimately adopted by Mr. La Mont. See* Appellee 334 and Appellee 276 at ¶16.[2] Had La Mont used the 6% value suggested by his primary data source, he could not have found that the discount rate had decreased during the course of the bankruptcy. It would have remained the same, upending the "primary driver" for his opinion that the Timberlands had not declined in value.

Accordingly, the evidentiary foundation, if any, for Mr. La Mont's selected discount rate for January 2007, must be found in the PowerPoint presentations that *someone else* authored in *mid-2008*, that used data on discount rate trends that originated *well* after the Petition Date. The only actual discount rate data in these presentations that would support La Mont's analysis came from unspecified periods including "*Fall* '07." Appellee 280 at MAR LAM 004960. There is no doubt he used hindsight evidence in his data set.

This hindsight bias was compounded by the fact that, unlike Fleming, La Mont made absolutely no effort to explain how he used his data to ensure that he did not use the hindsight

[2] La Mont eventually adjusted his discount rate for both the Petition and Confirmation dates because of the risks inherent in the California timber market.

evidence impermissibly; nor did he take any measures to ensure that there were no intervening market events that would make this hindsight evidence unreliable.

Moreover, MRC/Marathon simply ignores an e-mail authored by Sandy Dean, MRC's CEO, in September 2007, which asserted that discount rates for real estate assets such as the Timberlands had gone *up* (and not down) in the prior six months. Appellant 417 at p. 672. This e-mail is particularly revealing because it was not written for litigation purposes or at a time when Mr. Dean was trying to tailor his views to convince a court to reach a desired result; rather, that e-mail was written to set forth his actual economic views. *See id*.

2. Mr. La Mont Improperly Relied On Hindsight With Respect To Harvest Rates.

Mr. La Mont prepared a business plan for Marathon in late 2007 using an annual timber harvest of *78 MMBF*. Appellant 211 at p. 373:20 – 374:10. However, at the Confirmation Hearing, La Mont used a dramatically lower harvest rate of *60 MMBF* for his Confirmation Date appraisal (as of April of 2008). *Id*. at pp. 374:16 – 376:23. La Mont used these same lower harvest rate assumptions for his Petition Date valuation at the 507(b) Hearing. *Compare* Appellee 276 *with* Appellee 279. That lower rate cannot, however, be reconciled with information available as of the Petition Date. The only information available at the Petition Date was that (i) Scopac harvested 100 MMBF in 2006; (ii) Scopac (as reflected in a sworn affidavit filed by Dr. Jeffrey Barrett) was projecting a 100 MMBF harvest rate for 2007; and (iii) Scopac's projected harvest rate for 2007 was within Scopac's legally permitted harvest limit. Appellant 15 at ¶¶ 7 and 17.

La Mont's sole explanation for using a harvest rate for his Petition Date valuation that was far lower than Scopac's and his own previous projections was that he had a meeting with Dr. Barrett, former Vice President and interim CEO of Scopac, in *December 2007—eleven months*

after the January 2007 Petition Date. *See* Appellant 211 at p. 377:8. Whatever La Mont learned from Barrett at that subsequent meeting was far different than the knowledge available to those—including La Mont himself—who actually did valuations around the Petition Date. The only reasonable assumption is that La Mont must have learned something from Dr. Barrett that was not known and could not have been known at the Petition Date, and such is therefore impermissible hindsight evidence.

In sum, had Mr. La Mont relied only upon information that was available in or around January 2007 when formulating his projected harvest rates, projected log prices, and discount rate for purposes of valuing the Scopac Timberlands, his valuation of the Timberlands as of that date would have been significantly higher and would have reflected a diminution in the value of the Timberlands between the Petition Date and the Confirmation Date. Instead, his valuation testimony was colored by hindsight. The Bankruptcy Court's reliance on that testimony to find that the value of the Timberlands had at least remained constant throughout the bankruptcy proceedings constitutes legal error. That finding was also "clearly erroneous" because it was based on testimony as to harvest rates and discount rate assumptions as of January 2007 that found no support in the contemporaneously available data.

B. Mr. La Mont Also Lowered Log Prices In Contradiction Of His Own Contemporaneous Appraisals Conducted Before Being Employed By Appellees.

Mr. La Mont also admitted that, despite the fact that he had prepared a number of timberland appraisals in December 2006 that assumed that log prices would remain *flat*, his analysis of the Timberlands' value as of the Petition Date—made only *one month after* his prior appraisals—assumed a *decline* in log prices before returning to trend in 2010. Appellee 276 at ¶ 21. Mr. La Mont further admitted that he did not lower his projected log prices *for any other appraisal* until some time in the *Spring* of 2007, well after the *January* 2007 Petition Date. *See*

Appellant 211 at pp. 391:24 – 392:10; 403:15 – 405:18. By nevertheless reducing the projected log prices in his January 2007 Scopac valuation, something he did not do in his other contemporaneous appraisals, Mr. La Mont improperly reduced the projected cash flows attributable to the Timberlands as of January 2007 (a reduction compounded by the use of an artificially low harvest rate) and his estimated valuation of the Timberlands at that date. Such internal inconsistency constitutes clear error.

C. The Indenture Trustee Offered The Only Competent Valuation Testimony, Showing That The Fair Market Value Of The Timberlands Substantially Declined In Value.

The Indenture Trustee met its burden to show a substantial decline in the value of the Timberlands between the Petition Date and Confirmation. It offered the testimony of James Fleming, an appraiser with 30 years of experience, who was also a Registered Professional Forrester in California. He determined that the Timberlands were worth between $646 to $668 million as of the Petition Date. Brief at pp. 26-27 (suggesting that the Timberlands had declined by between $100 to $153 million); Appellant 113 at ¶ 158. This diminution is in excess of all the "other factors" noted by Appellees, and was relied on by the Bankruptcy Court as additional support for its ruling.

Beyond the expert testimony on value, the Bankruptcy Court found that the Timberlands value remained stable because "the forest grew so that there were more trees" and that the "tree planting and the watershed analysis did free up more areas for harvesting, which ultimately will lead to more value." Appellant 213 at p. 25:1-3, 25:9-12. Neither of these factors offset the decline in value of the Timberlands. First, even if excess growth occurred, this did not actually add to the overall value of the Timberlands because Fleming had already taken the growth rate of the trees into account in his analysis. Appellant 113 at ¶ 152. This growth rate is an essential component of any appraisal of the Timberlands because an appraiser would evaluate the

Timberlands according to the combined discounted value of both their future cash flows and the terminal value of the forest at the end of the projection period. To the extent that this tree growth is harvested, it is reflected in the cash flows expected during the projection period. To the extent that extra growth is not harvested, it raises the terminal value. Tree growth does not contribute additional value to the enterprise.

As for the tree planting and watershed analysis, these components add no more than $10 million to the estate. *See* Response Brief at p. 23. This obviously did not overcome the massive loss caused by the deterioration in the residential housing market and housing construction, as confirmed by Fleming's analysis.

D. "Foreclosure" Or "Liquidation" Value Vs. "Fair Market Value."

Appellees assert (p. 35) that the 507(b) Motion "failed as a matter of law because the relevant value under section 507(b) is foreclosure value." That assertion is, however, squarely at odds with the approach that MRC/Marathon adopted in presenting evidence of value as of January 2007 for purposes of determining whether any subsequent diminution in value had occurred. Both the Indenture Trustee and MRC/Marathon submitted valuation testimony as to the "*fair market value*" of the Timberlands as of the Petition Date, as determined in accordance with the definition of "fair market value" customarily used by appraisers. *See, e.g.,* Appellant 189 at pp. 351:18 – 352:14; Appellant 384 at ¶ 12; Appellant 396 at pp. 108-09. Thus, the Appellees waived any argument that "fair market value," as used in every party's valuation testimony, was the wrong standard, or that this testimony was legally irrelevant.

Moreover, applying a fair market value test to determine the change in value from the Petition Date to the Confirmation Hearing is consistent with case law holding that a bankruptcy court must apply a "fair market" or "going concern" value in connection with a motion for relief from the automatic stay, unless there is evidence that the reorganization efforts will not succeed.

See In re Helionetics, Inc., 70 B.R. 433, 444 (Bankr. E.D. Cal. 1987); *In re Automatic Voting Mach. Corp.*, 26 B.R. 970, 972 (Bankr. W.D.N.Y. 1983); *see also In re Davis*, 215 B.R. 824, 826 (Bankr. N.D. Tex. 1997) ("Where, as here, the debtor proposes to retain and use the vehicle, to adequately protect the secured creditor, the court may value the vehicle as of the petition date.").

Appellees argue that the Supreme Court's decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), which supports the use of fair market value where the debtor has continued to use the collateral, is inapposite simply because *Rash* dealt with valuation of a secured creditor's collateral for purposes of measuring the secured portion of its claim under section 506(a), rather than the virtually identical analysis under section 507(b). Appellees' efforts to disregard *Rash* fall short. *Rash* equates the value of a secured creditor's "interest" in collateral with the value of the collateral to the debtor, in light of the debtor's anticipated use of that collateral. *Id*. at 962-63. *Rash* addressed the valuation of a secured creditor's "interest" in collateral, interpreting statutory language (from section 506(a)) that is virtually identical to the language in section 507(b). *Compare* 11 U.S.C. § 506(a) (determining the extent of the secured portion of an undersecured creditor's claim according to "such creditor's interest . . . in such property") *with* 11 U.S.C. § 507(b) (noting the interest given adequate protection and compensated for under section 507(b) is "the interest of a holder of a [secured] claim").

The Supreme Court's decision in *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988), confirms that sections 506(a) and 507(b) should be interpreted similarly in this regard. In that case, the Court noted that the meaning of the phrase "value of such creditor's interest" in section 506(a) is identical to the phrase "value of such entity's interest" in the sections of the Code dealing with adequate protection. 484 U.S. at 372. A secured creditor's interest in collateral should be measured consistently throughout the

Bankruptcy Code, regardless of the purpose for which that interest is being measured, according to the anticipated use of the collateral.

None of the cases cited by the Appellees justify a departure from the holding in *Rash*. All but two of them, *In re Stembridge*, 287 B.R. 658 (Bankr. N.D. Tex. 2002), *rev'd*, 394 F.3d 383 (5th Cir. 2004), and *In re Johnson*, 247 B.R. 904 (Bankr. S.D. Ga. 1999), were decided before *Rash* and are no longer good law. Moreover, neither *Stembridge* nor *Johnson* establishes that a secured creditor's collateral should be valued solely on a foreclosure or liquidation value basis. In *Stembridge*, the Fifth Circuit essentially gave the secured creditor the benefit of the "fair market value" (as opposed to liquidation value) of its collateral *as of the petition date*. There, the Bankruptcy Court had determined at the outset of the case that the secured creditor (Chase) was entitled to adequate protection based on the foreclosure value of the collateral. The Fifth Circuit found it unnecessary to address Chase's appellate challenge on this point because, in addressing the primary issue on appeal, the Fifth Circuit held that for "cram down" purposes under a plan, the secured creditor was entitled to the "replacement value" (not "liquidation value," a lower number) of the collateral as of the petition date. 394 F.3d at 388 ("*[B]ecause we hold that Chase is entitled to the replacement value as of the petition date*, an amount that necessarily includes any deficiency in adequate protection payments, we need not address this question." (emphasis added)). Thus, the Fifth Circuit held that the secured creditor must be credited for the full replacement value of the collateral as of the petition date, less the amount of adequate protection payments actually received. The use of *foreclosure value* as of the Petition Date violates this approach.

In *Johnson*, the court determined that foreclosure value should be used solely because the debtor planned on surrendering the collateral in satisfaction of the debt. 247 B.R. 904, 910

(“Using the foreclosure value ensures the same result to both debtor and creditor” because the debtor sought to surrender the collateral). Thus, *Johnson* actually supports the approach advocated by the Indenture Trustee. In fact, the overwhelming majority of courts agree that the debtors’ anticipated use of the secured creditor’s collateral controls the method of valuation, even outside the context of section 506(a)—the provision at issue in *Rash*.[3]

Other cases cited by the Appellees are likewise inapposite, because the ultimate disposition of the collateral in those cases was its surrender to the secured creditor and foreclosure and not, as here, its retention and sale as a going concern. *See In re Modern Warehouse, Inc.*, 74 B.R. 173, 177 (Bankr. W.D. Mo. 1987) (collateral was ultimately foreclosed upon and liquidated by the creditor following conversion of case to chapter 7 case); *see also In re Johnson*, 247 B.R. at 904. Because the ultimate disposition of the collateral in these cases was a liquidation, it was appropriate to use liquidation value for an “apples-to-apples” approach in determining diminution in value. Here, in contrast, the ultimate disposition of the collateral was its retention and sale as a going concern; in that event, an “apples-to-apples” comparison requires the use of “fair market value” at the start date, as well as the end date, of the “diminution in value” analysis.

Based on the foregoing, the Bankruptcy Court erred as a matter of law in denying the 507(b) Motion on the basis that “there’s been no evidence as to a decline in the foreclosure value of the case.” *See* Appellant 213 at p. 23:20-23 and pp. 24:24 – 25:1.

[3] *See*, *e.g*., *In re Jenkin*s, 215 B.R. 689, 692 (N.D. Tex. 1997) (applying the *Rash* analysis to valuation of collateral for purposes of adequate protection); *In re TennOhio*, 247 B.R. 715 (E.D. Ohio 2000) (same); *see In re Helionetics, Inc.*, 70 B.R. 433, 444 (Bankr. E.D. Cal. 1987) (holding that a bankruptcy court must apply a “fair market” or “going concern” value in connection with a motion for relief from the automatic stay, unless there is evidence that the reorganization efforts will not succeed); *In re Automatic Voting Mach. Corp.*, 26 B.R. 970, 972 (Bankr. W.D.N.Y. 1983) (same).

E. Decline In The Value Of The Timberlands Need Not Have Resulted From The Debtors' "Use."

MRC/Marathon argue (p. 38) that the Indenture Trustee failed to show that any decline in value of the Timberlands resulted "because of the Debtors' use." This argument is merely an improper collateral attack the Bankruptcy Court's cash collateral orders, which provided in *unqualified* terms that the Noteholders were entitled to a superpriority administrative expense claim to the extent of any "post-petition diminution of its interest in the Prepetition Collateral [which includes the Timberlands] and the Cash Collateral." These orders imposed no limit on the claim based on the *cause* of that diminution. *See* Appellant 20 at ¶¶ 28-29.

Morever, Appellees assert a standard that is not the law and that the Bankruptcy Court did not adopt. Contrary to their theory, the decline in value that gives rise to an administrative claim under section 507(b) need not "result from the debtors' use." All that is required is that the section 507(b) administrative expense claim arise from the automatic stay under section 362; the use, sale or lease of the collateral under section 363; *or* the granting of a lien under section 364(d), and that "adequate protection" was provided and proved inadequate. 11 U.S.C. § 507(b). The secured creditor need not show that the use itself (rather than general market forces) caused the decline in collateral value that occurred while the automatic stay restrained the secured creditor. *See* cases cited in Brief at pp. 48-49.

The cases cited by the Appellees (p. 39) simply require an "actual use" of the collateral, or that "the Debtor use the collateral to operate a business or make an economic profit," as opposed to simply "retaining" collateral without using it. Appellees misunderstand the law applicable to claims awarded under section 507(b), as Appellees confuse the standard applicable to awarding superpriority administrative claims pursuant to section 507(b) with the standard

applicable to general administrative expense claims under section 503(b).[4] The majority of the cases cited by Appellees are either (i) cases holding that a secured creditor is not entitled to a claim under section 507(b) where the creditor did not receive adequate protection, as required under that section; or (ii) cases that did not arise in the context of section 507(b), but rather apply a straightforward analysis under section 503(b) to determine whether a claim is entitled to administrative priority due to the debtor's post-petition use of property.

Appellees argue (p. 39), without any evidentiary support, that "Scopac merely retained the vast majority of the Timberlands, without making any use of it." This is fiction. While Scopac may have harvested only some of the timber on the Timberlands, it had to "use" all of the Timberlands in its operations. Indeed, in the context of an earlier appeal in this case, the Fifth Circuit Court of Appeals concluded that Scopac had to, *inter alia,* actively manage the entire 210,000 acres of timberland, including addressing issues affecting harvest and regulatory compliance such as adjacency, threatened and endangered wildlife species restrictions, threatened and endangered plant species restrictions, erosion, and water quality. *Ad Hoc Group of Timber Noteholders v. The Pac. Lumber Co. (In re Scotia Pac. Co. LLC)*, 508 F.3d 214, 216-17, 224-25 (5th Cir. 2007) ("Scopac's timberland is clearly more than a passive investment. . . . Sophisticated operations take place on the timberland such as planning, growing, and maintaining the timber as well as building and maintenance of roads on the real estate which constitute substantial business other than the operation of the real property and activities

[4] Several of the cases cited by Appellees actually discuss this difference and explain that the fact that a debtor elects to provide adequate protection, in an effort to prevent a secured creditor from obtaining its collateral, automatically entitles the creditor to a claim under section 507(b) where the protection ultimately proves inadequate. *See, e.g., Grundy Nat'l Bank v. Rife*, 876 F.2d 361, 363-64 (4th Cir. 1989) (cited by Appellees and holding, "We are persuaded that § 507(b) converts a creditor's claim where there has been a diminution in the value of a creditor's secured collateral by reason of a § 362 stay into an allowable administrative expense claim under § 503(b).") (*citing In re Callister*, 15 B.R. 521, 528 (1981) (granting superpriority status, pursuant to §§ 503(b) and 507(b), for the loss in value of the collateral due to market forces and some loss through depreciation).

incidental thereto."). Scopac did not merely "retain" the vast majority of its Timberlands without making any use of them. *Id*. Rather, Scopac was required to engage in and maintain significant and complicated operations that involved the "use" of its entire Timberlands. *Id*.

II. The Cash Collateral Order Granted The Indenture Trustee A Superpriority Administrative Expense Claim With Respect To Diminution In Cash Collateral, Regardless Of When The Cash Collateral Was Generated.

In denying the Indenture Trustee's 507(b) claim, the Bankruptcy Court considered the value of the Cash Collateral at only two points in time: the Petition Date and Confirmation Date. This ignored cash that Scopac had generated from the sale of encumbered timber harvested during the course of the bankruptcy. The resulting cash increase was not reflected in an increase in the value of the Cash Collateral at Confirmation because more than $18 million of this cash was expended in payment of the estate's bankruptcy professionals. This caused a corresponding diminution in the Cash Collateral for which the Bankruptcy Court erroneously refused to compensate the Indenture Trustee.

A. The Indenture Trustee Had A Lien On All Proceeds And Products Of Its Collateral.

As adequate protection of the Indenture Trustee's interest in the Cash Collateral, Scopac's Final Order Authorizing Use of Cash Collateral Pursuant to Section 363 of the Bankruptcy Code (the "Cash Collateral Order") provided the Indenture Trustee with a "first priority, perfected replacement lien and security interest in all the property of Scopac of the same type as the Prepetition Collateral." Appellant 20 at ¶ 28. Identical language was included in every cash collateral order entered in the case. *See* Appellant 6, 13, 32, 92.

There is no dispute that the Indenture Trustee's liens extended to proceeds of the Pre-Petition Collateral, including revenue from timber sales. The relevant Deed of Trust granted the Indenture Trustee a security interest in "Mortgaged Property" that included, in addition to the

Timberlands and any harvested timber, any interest in proceeds and products of the collateral. Appellant 271 at § 3.1.

B. The Indenture Trustee Is Entitled To An Administrative Expense Claim For The Use Of Encumbered Proceeds To Pay Chapter 11 Professional Fees.

More than $18 million of the Proceeds generated during the case (i.e., the Indenture Trustee's Cash Collateral) was expended on the bankruptcy estate's chapter 11 professional fees. Those expenditures depleted the Cash Collateral with no corresponding benefit to the Indenture Trustee.[5] Thus, it is irrefutable that the Indenture Trustee's Cash Collateral—proceeds generated from the sale of Scopac timber during the bankruptcy proceedings—was diminished (i.e., consumed) by the payment of estate professional fees. Nevertheless, Appellees assert (p. 35), without authority, that "Section 507(b) does not entitle the Indenture Trustee to protection of the proceeds of its collateral" and that "Court-approved use of cash collateral created during the case to pay administrative expenses of the estate is irrelevant for determining a 507(b) claim." These assertions are wrong and conflict with the plain and unambiguous terms of the Bankruptcy Court's cash collateral orders, which expressly granted the Indenture Trustee a Replacement Lien on Proceeds and an administrative claim for the diminution of its interest in Cash Collateral—including cash collateral created during the case. *See* Appellant 20 at ¶ 28.

The Appellees' theory that the cost of all estate professional fees incurred during the bankruptcy case and paid out of the Cash Collateral should be borne solely by the Indenture Trustee, without compensation, flies in the face of the law and the cash collateral orders. A secured creditor cannot be forced to fund the payment of unsecured administrative claims from its collateral—at least not without adequate protection for its interest in the consumed collateral.

[5] In fact, these expenditures resulted in a detriment to the Indenture Trustee, since they were used to fund litigation by Scopac and the Creditors' Committee against the Indenture Trustee and, among other things, force the Indenture Trustee to incur its own professional fees in response.

See In re Flagstaff Food Serv. Corp., 762 F.2d 10 (2d Cir. 1985); *In re Flagstaff Food Serv. Corp.,* 739 F.2d 73 (2nd Cir. 1984). Code section 506(c) provides that a trustee may recover, from property securing an allowed claim, the reasonable, necessary costs of preserving or disposing of such property *to the extent of any benefit to the secured creditor*, thereby making it clear that (at least in the absence of adequate protection) administrative expenses that do not benefit the secured creditor cannot be charged against its collateral. *TNB Fin., Inc. v. James F. Parker Interests (In re Grimland, Inc.)*, 243 F.3d 228, 232-33 (5th Cir. 2001) ("We have interpreted [section 506(c)] to require a quantifiable and direct benefit to the secured creditor; indirect or speculative benefits may not be surcharged, nor may expenses that benefit the debtor or other creditors."). Thus, the Bankruptcy Court *could not* permit the Indenture Trustee's Cash Collateral to be used to pay estate professional fees without providing the Indenture Trustee with adequate protection for that use. *See* Appellant 20 at ¶ 19. Accordingly, although the cash collateral orders did permit the use of Cash Collateral to pay chapter 11 estate professional fees, those orders were, as a matter of law, required to (and did) provide the Indenture Trustee with various forms of adequate protection, including a superpriority administrative claim for the post-petition diminution of Cash Collateral resulting from such payments.

Moreover, the estate professional fees that were paid from the Indenture Trustee's Cash Collateral were administrative claims against Scopac's estate that, if not paid from the Indenture Trustee's Cash Collateral, would have had to have been paid by MRC/Marathon (or their new entity) in order for them to confirm their Plan. To confirm their Plan, MRC/Marathon, as the plan proponents, had to ensure that all administrative claims (including unpaid estate professional fees) would be paid in full, *see* 11 U.S.C. § 1129(a)(9)(A), and section 2.1 of the MRC/Marathon Plan so provided. *See* Appellant 134. The effect of the cash collateral orders

was that, to the extent that the Indenture Trustee's Cash Collateral was diminished by the payment of administrative claims for estate professional fees, the Indenture Trustee had an administrative claim for this diminution that must also be paid in cash in order for MRC/Marathon to confirm their Plan. Any other result would confer a windfall on MRC/Marathon at the expense of the Indenture Trustee.

Finally, as several courts have noted, "parties subjected to loss and expense as a result of the administration of a bankruptcy estate are entitled to be made whole as a matter of fundamental fairness and should be allowed an administrative claim to implement that result." *Brandt v. Lazard Freres & Co., L.L.C. (In re Healthco Int'l, Inc.)*, 310 F.3d 9, 13 (1st Cir. 2002); *see also Tama Beef Packing, Inc.*, 283 B.R. 274, 276 (Bankr. N.D. Iowa 2002); *In re Hildebrand*, 205 B.R. 278, 286 (Bankr. D. Colo. 1997); *In re G.I.C. Gov't Secs., Inc.*, 121 B.R. 647 (Bankr. M.D. Fla. 1990) (analyzing *Reading Co. v. Brown*, 391 U.S. 471, 483 (1968)). The Indenture Trustee has lost in excess of $18 million of its Cash Collateral as a result of the administration of Scopac's bankruptcy case, and it is entitled to compensation for that loss.

C. The "Carve-Out" For Estate Professional Fees Did Not Preclude A Claim By The Indenture Trustee For The Diminution Caused By The Payment of Those Fees From Its Cash Collateral.

The cash collateral orders provided that the liens and superpriority cost of administration claim granted to the Indenture Trustee pursuant to these orders would be

> subject and subordinate to a carve-out (the "Carve-out") for the payment of allowed consultant and professional fees and disbursements incurred by the consultants and professionals retained, pursuant to Bankruptcy Code §§ 327 or 328, by Scopac and any committee appointed under 11 U.S.C. § 1102.

Appellant 20 at ¶ 32 (emphasis added).

Although the "carve-out" permitted the payment of estate professionals ahead of the Indenture Trustee's administrative claim, that "carve out" did *not eliminate* the Indenture

Trustee's administrative claim for any diminution in its Cash Collateral resulting from the use of collateral Proceeds to pay those estate professionals. Rather, the "carve out" simply meant that if there was insufficient value to pay both sets of administrative claims, those of the estate professionals would be paid first. The fact remains, however, that under section 1129(a)(9)(A), the MRC/Marathon Plan was required to provide for the payment in full of all administrative claims—subordinated or not—in order to be confirmed, and it did so.

As noted by the leading treatise on bankruptcy law, "[a] creditor whose claim has been subordinated does not cease to be a creditor under the Code. The creditor continues to enjoy all of the rights of a creditor except to share in the distribution of the estate on a parity with the other creditors." 4 LAWRENCE P. KING, COLLIER ON BANKRUPTCY, ¶ 510.03[2] (15th ed. rev. 2008). Accordingly, by subordinating the Indenture Trustee's administrative claim, the Bankruptcy Court did not preclude or eliminate any administrative claim for diminution in Cash Collateral caused by the payment of professional fees.

D. The Indenture Trustee Requested An Administrative Expense Claim For The Diminution Of Its Cash Collateral To Pay Estate Professional Fees In Its Original Motion.

As a technical defense to the Indenture Trustee's administrative expense claim for the diminution in Cash Collateral caused by its use to pay estate professionals, Appellees assert (p. 34) that "the Indenture Trustee did not argue that it was entitled to operating income as 'proceeds of collateral' in support of its 507(b) claim in the Bankruptcy Court, and thus this argument cannot be raised on appeal." This assertion is disingenuous. On its face, the Indenture Trustee's 507(b) Motion—the very first pleading addressed to the issue—asserted that the Indenture Trustee was entitled to a "superpriority administrative expense claim for the cash collateral that has been expended by Scopac, *including but not limited to the over $20 million in professional fees and other expenses paid by Scopac*." *See* Response Brief at p. 9 (emphasis

added); *see also* Appellant 97 at ¶ 9. At the 507(b) Hearing, evidence was presented establishing the amount of the Indenture Trustee's Cash Collateral that was expended by Scopac to pay professional fees. *See, e.g.,* Appellant 211 at pp. 237:13 – 238:5. Accordingly, the Appellees' asserted defense is entirely without merit.

For all the foregoing reasons, the Indenture Trustee is entitled to the reversal of the 507(b) Order and the entry of an order granting the Indenture Trustee an administrative expense claim under section 507(b) in the sum of at least $18 million, to be paid in accordance with the terms of the MRC/Marathon Plan.

E. The Bankruptcy Court Erred In Deducting $8.9 Million From The Petition Date Cash Collateral For Which The Indenture Trustee Was Entitled To Protection And Compensation.

As a separate matter, the Bankruptcy Court also erred in deducting, from the Cash Collateral existing as of the Petition Date for which the Indenture Trustee was entitled to protection, $8.9 million on account of post-petition professional fees paid to the Indenture Trustee during the bankruptcy proceedings. This deduction was erroneous because, as explained at pages 44-45 of the Appellants' Opening Brief, the $8.9 million was paid out of post-petition revenues derived from the sale of encumbered timber, which revenues represented *additional* Cash Collateral; hence, the Bankruptcy Court "double counted" when it deducted the same $8.9 million that was paid from post-petition revenues from the "credit" to which the Noteholders were entitled for their Petition Date Cash Collateral.

The Appellees' assertion (p. 33) that the Indenture Trustee's counsel "acknowledged" that "the Indenture Trustee was not entitled to payment of its legal fees unless it could prove that it had been oversecured" plainly mischaracterizes the Indenture Trustee's statement. As the Bankruptcy Court itself recognized, counsel's point was that where a creditor is undersecured, its fees are paid *out of its collateral*. *See id.* (citing July 3, 2007 Hr'g Tr.). That is what happened

when the $8.9 million in post-petition professional fees of the Indenture Trustee was paid out of Scopac's post-petition, encumbered revenues. Since the $8.9 million was properly paid out of the Indenture Trustee's collateral proceeds, that amount should not also have been deducted from the Indenture Trustee's interest in the Cash Collateral on hand as of the Petition Date.

III. The Indenture Trustee's Reply To Various Assertions By Appellees.

A. Timing Of Indenture Trustee's 507(b) Motion.

Appellees complain (pp. 8-9) that the Indenture Trustee "advised the Court that its 507(b) claim could exceed several hundred million dollars" only at a June 6, 2008 status conference. This argument is not only irrelevant for purposes of determining the merits of this appeal, but it also distorts the record.

The MRC/Marathon Plan provided that an Administrative Expense Claim must be filed no later than the "Administrative Expense Claims Bar Date," which did not occur until "*the thirtieth day after the Effective Date* or such other date as may be fixed by order of the Bankruptcy Court." Appellant 86, Exhibit A-1, at § 2.2 and Appendix A. Thus, MRC/Marathon took the risk of unknown and unasserted administrative claims, and the Indenture Trustee's administrative claim could have been properly asserted up to 30 days *after* the Effective Date occurred and the transaction closed.

Moreover, the assertion that the Indenture Trustee did not inform the Bankruptcy Court of the significant nature of its 507(b) claim until June 6, 2008, ignores the fact that the Bankruptcy Court was told of this substantial claim over one month earlier, on May 2, 2008—the day after the 507(b) Motion was filed. *See* Appellant 201 at p. 17:3-5 (Mr. Greendyke: "We have also filed a significant administrative claim at the Scopac level that the Court needs to be aware of and take notice of."). Indeed, it was not until the Bankruptcy Court made its Confirmation Hearing Timberlands value finding of $510 million (based in large part on the

"drop" in value of the Timberlands) did the full magnitude of the 507(b) claim become apparent to all parties and the Court. And it was then, for the first time, that MRC/Marathon told the Bankruptcy Court that they needed an immediate hearing on the 507(b) claim. Appellant 207 at p. 15:18-24

B. Separateness Of Section 507(b) Hearing.

The Appellees also argue (p. 9) incorrectly that "as a part of the confirmation proceedings, the Bankruptcy Court held a hearing on the 507(b) Motion." Contrary to this assertion, the 507(b) Motion was not "part of the confirmation hearing"; the Bankruptcy Court expressly *closed* the record of the Confirmation Hearing and made its confirmation findings *before the 507(b) Hearing even began*, and issued a *separate* order on the 507(b) Motion. *See* Appellant 214 at pp. 18:14 – 19:4; *see also id*. at pgs 20:24 – 21:7; *id*. at pp. 88:19 – 89:1; *id*. at p. 154:11-13; Appellant 135.

As a matter of law, the 507(b) Hearing and the Confirmation Hearing clearly involved separate contested matters that were commenced by separate pleadings. MRC/Marathon's attempt to retroactively consolidate the two discrete proceedings for purposes of this appeal is a transparent attempt to lend credence to their equitable mootness argument based on substantial consummation. *But see* Fifth Circuit Oral Argument, Oct. 6, 2008, at 19:50-20:02 (Chief Justice Edith Jones: ". . . [Y]ou fellows [MRC/Marathon] have done about as speedy a job of trying to undermine our appellate review as I've ever seen in nearly 25 years on the bench. So what's equitable about that situation?").[6]

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[6] *Available at* http://www.ca5.uscourts.gov/OralArgumentRecordings.aspx?prid=280244

C. Failure To Seek Stay Relief.

Finally, Appellees argue (p. 40) that the Indenture Trustee is not entitled to a superpriority claim because "[t]he Indenture Trustee never sought relief from the automatic stay." The Bankruptcy Court, however, ascribed no significance to that "failure," and for good reason. The functional equivalent of stay relief was sought when the Indenture Trustee unsuccessfully moved to have the case treated as a single asset real estate case (the "SARE Motion"), *In re Scotia Pac. Co. LLC*, 508 F.3d at 225; and the Bankruptcy Court acknowledged that it would not have granted relief from the stay, even if requested. *See* Appellant 210 at p. 72:16-18 and 76:12-18 (The Bankruptcy Court: "Well, why would it make any more sense then if they [the Noteholders], at the time they filed the SAR[E] motion, said: In the alternative, lift the stay? And I would have denied the motion to lift the stay; I denied the SAR[E] motion."). Accordingly, any assertion that the filing of a lift stay motion would have affected the Bankruptcy Court's ruling is simply misplaced.

CONCLUSION AND PRAYER

For the reasons and based on the authorities presented above, this Court should reverse the Bankruptcy Court's 507(b) Order and order that the Indenture Trustee is entitled to a superpriority administrative expense claim pursuant to 11 U.S.C. § 507(b) in the amount of at least $162.9 million. Appellants' request is based upon: (i) the depletion of Scopac's Cash Collateral to pay estate professional fees (from which the Indenture Trustee received no benefit) in the undisputed amount of $18 million; (ii) the improper deduction of an undisputed $8.9 million from the compensation to which the Indenture Trustee was entitled for the Cash

Collateral on hand as of the Petition Date; and (iii) the decline in the value of the Timberlands from the Petition Date through the Confirmation Date in an amount not less than $136 million.[7]

Dated: December 5, 2008
Houston, Texas

Respectfully submitted,

FULBRIGHT & JAWORSKI L.L.P.

By: _*/s/ William R. Greendyke*_______
William R. Greendyke (SBTX 08390450)
(S.D. Tex.: 576573)
Attorney-in-Charge

Zack A. Clement (SBTX 04361550)
(S.D. Tex.: 06445)
R. Andrew Black (SBTX 02375110)
(S.D. Tex.: 09040)
Jason L. Boland (SBTX 24040542)
(S.D. Tex.: 37238)
Mark Worden (SBTX 24042194)
(S.D. Tex.: 36997)
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
Telephone: (713) 651-5151
Facsimile: (713) 651-5246

-and-

[7] The diminution in value of the Timberlands is based upon the testimony of James Fleming and the Bankruptcy Court's own findings. James Fleming, who offered the only appraisal not skewed by hindsight or based on unsupportable log pricing, concluded that the Timberlands were worth $646 million on the Petition Date. *See* Appellant 219; Appellant 211 at p. 105:17; *see also* Brief at p. 10. The Bankruptcy Court found that the value of the Timberlands at Confirmation was $510 million, and did not revisit that decision at the 507(b) hearing. Appellant 113 at pp. 31, 61; Appellant 210 at p. 32:15-25. Comparison of Fleming's Petition Date value against the Bankruptcy Court's Confirmation Date value yields a net decline of $136 million.

Toby L. Gerber (SBTX 07813700)
(S.D. Tex.: 21903)
Louis R. Strubeck, Jr. (SBTX 12425600)
(S.D. Tex.: 15416)
O. Rey Rodriguez (SBTX 00791557)
(S.D. Tex.: 19068)
2200 Ross Avenue, Suite 2800
Dallas, Texas 75201-2784
Telephone: (214) 855-8000
Facsimile: (214) 855-8200

Counsel for The Bank of New York Mellon Trust Company, N.A. (f/k/a The Bank of New York Trust Company, N.A.), as Indenture Trustee for the Timber Notes

-and-

STUTMAN, TREISTER & GLATT P.C.

*/s/ Eric D. Winston*____________________

Eric D. Winston (Cal. 202407)
(admitted *pro hac vice*)
Attorney-in-Charge

Isaac M. Pachulski (Cal. 62337)
(*pro hac vice* admission pending)
Jeffrey H. Davidson (Cal. 73980)
(admitted *pro hac vice*)
1901 Avenue of the Stars, 12th Floor
Los Angeles, California 90067
Telephone: (310) 228-5600
Facsimile: (310) 228-5788

COUNSEL FOR APPELLANTS ANGELO, GORDON & CO., L.P., AURELIUS CAPITAL MANAGEMENT, LP, AND DAVIDSON KEMPNER CAPITAL MANAGEMENT LLC

-and-

AKIN GUMP STRAUSS HAUER & FELD LLP

_/s/ *Charles R. Gibbs*___________________
Charles R. Gibbs (SBTX 07846300)
(S.D. Tex.: 00177)
Attorney-in-Charge

David F. Staber (SBTX 18986950)
(S.D. Tex.: 437693)
J. Carl Cecere (SBTX 24050397)
(S.D. Tex.: 827732)
1700 Pacific Avenue, Suite 4100
Dallas, Texas 75201
Telephone: (214) 969-2800
Facsimile: (214) 969-4343

-and-

Murry Cohen (SBTX 04508500)
(S.D. Tex.: 570348)
1111 Louisiana Street, 44th Floor
Houston, Texas 77002-5200
Telephone: (713) 220-5800
Facsimile: (713) 236-0822

COUNSEL FOR APPELLANTS CSG INVESTMENTS, INC. AND SCOTIA REDWOOD FOUNDATION, INC.

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of Appellants' Reply Brief has been served on counsel listed below by CM/ECF and electronic mail on this 5th day of December, 2008.

__*/s/ Mark A. Worden*______________
Mark A. Worden
1301 McKinney, Suite 5100
Houston, Texas 77010

Counsel for CGS Investments and Scotia Redwood Foundation
Charles R. Gibbs
David F. Staber
Sarah Ann Link Schultz
Akin Gump Strauss Hauer & Feld LLP
1700 Pacific Avenue
Dallas, TX 75201
cgibbs@akingump.com
dstaber@akingump.com
sschultz@akingump.com

Counsel for Angelo, Gordon & Co. L.P., Aurelius Capital Management, LP and Davidson Kempner Capital Management LLC
Isaac M. Pachulski
Jeffrey H. Davidson
Eric D. Winston
Stutman Treister & Glatt PC
1901 Avenue of the Stars, 12th Floor
Los Angeles, CA 90067
ipachulski@stutman.com
jdavidson@stutman.com
EWinston@Stutman.com

Counsel for Debtor Scotia Pacific LLC
Kathyrn Coleman
Gibson Dunn & Crutcher LLP
200 Park Avenue, 47th Floor
New York, NY 10166-0193
kcoleman@gibsondunn.com

Eric J. Fromme
Gibson Dunn & Crutcher LLP
3161 Michaelson Drive
Irvine, CA 92612-4412
efromme@gibsondunn.com

Kyung S. Lee
Diamond McCarthy
909 Fannin
Suite 1500
Houston, Texas 77010
KLee@diamondmccarthy.com

Counsel for the Palco Debtors
Shelby A. Jordan
Nathaniel Peter Holzer
Jordan, Hyden, Womble, Culbreth & Holzer P.C.
500 N. Shoreline Drive, Suite 900
Corpus Christi, TX 78471
sjordan@jghwclaw.com
pholzer@jhwclaw.com

Gary M. Kaplan
Howard Rice
Three Embarcadero Center
7th Floor
San Francisco, CA 94111
gmkaplan@howardrice.com

Jack L. Kinzie
James R. Prince
Baker Botts LLP
2001 Ross Avenue
Dallas, TX 75201-2980
Jack.Kinzie@bakerbotts.com
Jim.Prince@bakerbotts.com

Counsel for Marathon Structured Finance Fund. LP
David Neier
Winston & Strawn, LLP
200 Park Avenue
New York, NY 10166
DNeier@winston.com

Counsel for Bank of America
Evan M. Jones
O'Melveny & Myers LLP
400 South Hope Street
Los Angeles, CA 90071-2899
ejones@omm.com

Counsel for Mendocino Redwood Company, LLC
Allan S. Brilliant
Goodwin Procter LLP
The New York Times Building
620 Eighth Avenue
New York, NY 10018-1405
abrilliant@goodwinprocter.com