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. L.P., 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

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(1) 08–40746; *The Bank of New York Mellon Trust Company, N.A., as Indenture Trustee for the Timber Notes; Angelo Gordon & Co L.P., 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; Pacific Lumber Co.; The Pacific Lumber Company; United States of America; California State Agencies, Appellees.*

(2) The undersigned counsel of record certifies that the listed persons and entities (on the following pages) as described in the fourth sentence of Rule 28.2.1 have an interest in the outcome of this case. These representations are made in order that the judges of this Court may evaluate possible disqualification or recusal.

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STATEMENT REGARDING ORAL ARGUMENT

On August 5, 2008, this Court granted oral argument during the week of October 6, 2008.

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STATEMENT OF JURISDICTION

On July 8, 2008, the United States Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court") entered an order confirming a plan of reorganization (the "Confirmation Order"). Excerpt-H, Attachment 1/Dkt-3302 (12:2336).[1] The Confirmation Order is an appealable judgment under 28 U.S.C. § 157(b)(2)(L). *See, e.g., I.R.S. v. Prescription Home Health Care, Inc. (In re Prescription Home Health Care, Inc.)*, 316 F.3d 542, 547 (5th Cir. 2002).

On July 9, 2008, Appellants filed notices of appeal of the Confirmation Order. *See* Excerpts-B/Dkt-3304, C/Dkt-3305, D/Dkt-3314, E/Dkt-3315, F/Dkt-3317. The Bankruptcy Court certified a direct appeal to this Court (Appellant-369) which this Court accepted and set for expedited consideration. Thus, jurisdiction exists under 28 U.S.C. § 158(d)(2). *See Drive Fin. Servs., L.P. v. Jordan*, 521 F.3d 343, 345 (5th Cir. 2008).

ISSUES PRESENTED

1. Did the Plan[2] violate the "absolute priority" rule by using the proceeds of a sale of secured creditors' collateral to pay junior unsecured creditors?

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[1] References to the Record Excerpts are denoted as: "Excerpt-#." References to material on the docket, including transcripts, are denoted as "Dkt-# (Record Volume: Page number assigned by district clerk, if available)." References to exhibits in the record are denoted as: "Appellant-##" for items designated by the Appellants, and "Appellee-##" for items designated by the Appellees.

[2] The First Amended Joint Plan of Reorganization for the Debtors, as Further Modified, with Technical Amendments, Proposed by Mendocino Redwood Company, LLC, Marathon Structured Finance Fund L.P., and Official Committee of Unsecured Creditors (the "MRC/Marathon Plan"). Excerpt-H, Attachment 1/Dkt-3300 (12:2453).

2. Did the Plan's provision for a forced non-market sale of collateral, free and clear of liens over the secured creditor's objection and without preserving the secured creditor's statutory credit bid right under 11 U.S.C. § 363(k), violate the "fair and equitable" requirement of 11 U.S.C. § 1129(b)?

3. Was the Bankruptcy Court's determination that the Plan's treatment of Appellants' secured claims satisfied the "indubitable equivalent" requirement of 11 U.S.C. § 1129(b)(2)(A)(iii) contrary to the record and erroneous as a matter of law?

4. Did the Plan provide for an illegal, *de facto*, substantive consolidation of six bankruptcy estates by diverting consideration from the sale of one estate's assets to pay creditor claims of the other estates and by eliminating intercompany claims?

5. Did the Bankruptcy Court violate 11 U.S.C. § 1129(a)(9)(A) by confirming a plan that failed to provide for the cash payment of the estates' intercompany administrative claims against each other?

6. Did the Plan's (i) classification of unsecured claims of equal priority into two separate classes and (ii) artificial "impairment" of one class of secured claims, both constitute illegal methods of attempting to satisfy 11 U.S.C. § 1129(a)(10)?

7. Did the Plan discriminate unfairly against unsecured deficiency claims in one class by providing for a substantially higher percentage recovery to another class of unsecured claims of equal priority, in violation 11 U.S.C. § 1129(b)(1)?

8. Were the third-party exculpation and release provisions of the Plan illegal?

STANDARDS OF REVIEW

This Court reviews a Bankruptcy Court's findings of fact for clear error and gives conclusions of law plenary review. Mixed questions of fact and law are reviewed *de novo*. *Highland Capital Mgmt. LP v. Chesapeake Energy Corp.*, 522 F.3d 575, 583 (5th Cir. 2008). However, when, as here, a trial court adopts virtually verbatim findings proposed by the prevailing party below, review of the lower court's findings should be "approach[ed] with greater caution." *McLennan v. Am. Eurocopter Corp., Inc.,* 245 F.3d 403, 469 (5th Cir. 2001); *In re Complaint of Luhr Bros., Inc.*, 157 F.3d 333, 338 (5th Cir. 1998).

The application of legal principles and the ultimate conclusions regarding whether the Plan (i) violated the "absolute priority" rule, (ii) violated the "fair and equitable" standard, (iii) provided for an illegal *de facto* substantive consolidation of Scopac and Palco, (iv) improperly released intercompany claims, (v) improperly classified and discriminated against classes of claims; and (vi) contained illegal third party releases are reviewed de novo. *See In re Sunflower Racing, Inc.*, 226

B.R. 673, 685, 687, 690, 692 (D. Kan. 1998); *In re Inv. Co. of The S.W. Inc.*, 341 B.R. 298. 317-18 (B.A.P. 10th Cir. 2006); *In re Way Apartments, D.T.*, 201 B.R. 444, 456 (N.D. Tex. 1996).

STATEMENT OF THE CASE

This is an appeal from an order that confirmed, over the Appellants' objection, a plan of reorganization for six separate debtors in their respective separate bankruptcy cases under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code" or "Code"),[3] 11 U.S.C. § 1101 *et. seq.*

STATEMENT OF FACTS

I. The Major Parties.

The Pacific Lumber Company ("Palco") one of the debtors in the cases below, was once the owner of over 200,000 acres of primarily redwood forest in Northern California (the "Timberlands"), and, together with certain of its affiliates (the "Palco Debtors") continued to own three sawmills, a co-generation plant and the entire town of Scotia, California.[4]

Scotia Pacific Company LLC ("Scopac") is a wholly-owned subsidiary of Palco and a debtor in its own bankruptcy case. Over nine years ago, Palco transferred ownership of the Timberlands to Scopac so that this separate corporate

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[3] Unless otherwise indicated, references to "section" are references to the Bankruptcy Code.

[4] *See* Dkt-426 (Schedule A) (48:14878); *see also* Dkt-11, ¶¶ 5, 91 (53:16804, 16836).

entity could exclusively use them as collateral for the issuance of over $867.2 million in secured notes to the public market. Dkt-11, ¶ 5 (53:16804).

The Bank of New York Mellon Trust Company, N.A. (the "Indenture Trustee") is the Indenture Trustee under the indenture dated July 20, 1998 (the "Indenture"), pursuant to which Scopac issued its secured notes ("Timber Notes" or "Notes"). Appellant-514. The other Appellants herein are all owners of Timber Notes ("Noteholders").

Marathon Structured Finance Fund, L.P. ("Marathon") is an undersecured creditor of the Palco Debtors (but not a creditor of Scopac) who, along with MRC, proposed the plan of reorganization for Scopac and the Palco Debtors confirmed by the Bankruptcy Court (the "MRC/Marathon Plan" or "Plan"), pursuant to which Marathon receives not only the value of all of its "Palco" collateral, but also an interest in assets that belonged to Scopac, against whom it had no claim.

Mendocino Redwood Company, Inc. ("MRC") is a competitor of Scopac (but not a creditor of any Debtor), previously interested in purchasing the Timberlands, who, along with Marathon,[5] proposed the MRC/Marathon Plan. The Plan creates "Newco," an entity owned 85% by MRC and 15% by Marathon, that purchases substantially all of Scopac's assets that secured the Noteholders' claims, free and clear of their liens, in a "one bidder" sale, without any competitive

[5] MRC and Marathon are collectively referred to as "MRC/Marathon".

bidding or right by Noteholders to credit bid their claims if they believed the purchase price was too low. Dkt-2401, pgs. 43-56 (25:6664-6677).

II. The Timber Notes, Scopac's Corporate Separateness, The Debtors' Bankruptcies.

In 1998, Palco needed financing. To obtain that financing on the best terms and "to facilitate the sale" of the Notes to the public market, Palco created Scopac as a special purpose entity to which it transferred ownership of its most valuable assets, the Timberlands. Dkt-11, ¶ 5 (53:16804). Scopac then issued and sold $867.2 million in Notes pursuant to the Indenture, secured by essentially all of Scopac's property. Dkt-11, ¶¶ 16, 21 (53:16809, 16811); *see also* Appellant-516. The Notes are obligations solely of Scopac and were not guaranteed by Dkt-11, ¶ 17 (53:16809).

To obtain these more favorable financing terms from the public market, Scopac agreed to extensive covenants requiring it to maintain its separate identity from Palco and prohibiting any commingling of its assets and debts with those of Palco. Appellant-514, § 4.5; Appellant-513, § 2.6. Prior to bankruptcy, Scopac assiduously complied with these separateness covenants. Dkt-11, ¶¶ 6, 13-14 (53:16804, 16808).

On January 18, 2007 (the "Petition Date"), almost nine years after the Notes were issued, Scopac and the five Palco Debtors (collectively, the "Debtors") each filed a separate voluntary petition for relief under chapter 11 of the Code.

Approximately $714 million in principal and $26 million in interest was then outstanding on the Notes. Dkt-11, ¶¶ 7, 17-18 (53:16809-10); *see also* Dkt-420 (Schedule D) (50:15510). Although the Debtors' separate chapter 11 cases were jointly administered procedurally (*see* FED. R. BANKR. P. 1015(b)-(c)), the Debtors were not substantively consolidated and remained separate entities in separate bankruptcy cases, with separate assets, liabilities and bankruptcy estates.

III. <u>Palco's Separate Marathon Loans and Ongoing Losses.</u>

Marathon was a lender to Palco holding a $85 million term loan secured by substantially all the Palco Debtors' assets (except for Palco's ownership of Scopac), but not by any Scopac assets. Dkt-941, ¶¶ 9-10 (53:16654). Six months prior to Palco's bankruptcy, Marathon made a revolver loan to Palco secured by the same collateral. *Id.* Palco continued to lose money after the Petition Date and obtained post-bankruptcy financing from Marathon; ultimately Palco owed Marathon about $85 million on the term loan and $75 million on the "debtor-in-possession" financing (including $35 million of new funds loaned post-bankruptcy) under the revolver loan). Dkt-1165 (53:16665). Marathon later admitted that it was significantly undersecured, valuing its collateral at approximately $110 million compared to $160 million in debt. Dkt-2795, pg. 243:1-20. Thus, there were no unencumbered Palco assets whose value could be used to pay Palco's unsecured creditors. Appellee-209, ¶ 6.

Palco continued to suffer negative cash flow during the bankruptcy proceedings, and by November 2007 had depleted all available credit from Marathon. Dkt-2010. In order to prop up the *Palco* estate, the Bankruptcy Court, over the Indenture Trustee's objection, approved a material modification of the terms under which Palco purchased logs from Scopac to supply Palco's sawmill. This modification drained Scopac's cash reserves and created a large post-petition administrative claim of Scopac against Palco for unpaid log deliveries (a claim that was subject to the Indenture Trustee's lien and will not be paid under the Plan). Dkt-1282 (44:13562), Dkt-1294 (44:13554); Excerpt-H, Attachment 1/Dkt-3300, § 4.10.2. (12:2465)

IV. Filing of Plans.

After the Petition Date, the Debtors had the exclusive right to file a plan of reorganization pursuant to Code section 1121. On January 4, 2008, after multiple contested extensions of this exclusivity period,[6] the Bankruptcy Court entered an order partially terminating the Debtors' plan exclusivity by permitting *only* the Debtors, the Indenture Trustee, Marathon, and the Creditors' Committee (which

[6] *See* Dkt-3086, pg. 67:15-20 (acknowledging that exclusivity was lifted "not as early as the noteholders wanted").

later aligned itself with Marathon and became a co-proponent of the Plan)[7] to file plans of reorganization and gave them less than four weeks to do so. Dkt-2004 (31:8859).

MRC, a self-styled "hostile acquirer,"[8] joined with Marathon and filed a plan for the Palco Debtors and Scopac [Dkt-2206 (30:8723)], even though neither MRC nor Marathon was a creditor of Scopac and the separate bankruptcy estates had never been consolidated. The Indenture Trustee filed a plan solely for Scopac, the only entity of which it and the Noteholders were creditors (as amended, the "Indenture Trustee Plan"). Dkt-2211 (29:8349). The Debtors filed three alternative plans of their own. Dkt-2208-2210 (30:8481-8400).

V. Structure of the MRC/Marathon Plan.

The MRC/Marathon Plan provides for the dissolution of the Debtors; the cancellation of intercompany claims; the formation of two new entities, Newco and Townco, which obtain the Debtors' assets; and the contribution by MRC/Marathon

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[7] A single Committee of Unsecured Creditors had been appointed to represent the interests of all unsecured creditors in all six of the separate estates but its membership was made up primarily of creditors of Palco. Dkt-86 (53:16694), Dkt-426 (schedule F)(48:14878), Dkt-540. The inherent conflict of interest of these committee members and their counsel was clearly demonstrated by their support of the MRC/Marathon Plan which benefited unsecured creditors of the Palco Debtors holding $10 million in claims at the expense of unsecured creditors of Scopac holding over $227 million of claims. Dkt-2401, pg. 51 (25:6672). The Committee made no pretense of trying to protect the deficiency claim of the Noteholders, the largest unsecured claim in these cases.

[8] *See* Dkt-3085, pg. 16:11-16 (Comments by MRC counsel).

of cash[9] to Newco. *See* Excerpt-H, Attachment 1, Dkt-3300, §§ 4.10.2, 7.1, 7.9 (12:2465, 2468, 2471) Marathon, the undersecured creditor of the Palco Debtors, receives all of the value attributable to its collateral through its receipt of 100% of the equity of Townco, part of the equity of Newco, and a note from Newco. Scopac's encumbered assets are sold to Newco free and clear of the Indenture Trustee's lien in exchange for Newco's agreement to pay claims against Scopac and Palco under the Plan. Dkt-2795, pg. 193:7-13; pg. 197:4-10.

A. **<u>The Palco Debtors' Assets Solely Benefit Marathon.</u>**

Almost all of the Palco Debtors' assets, including the town of Scotia, are transferred to Townco, an entity owned 100% by Marathon. Excerpt-H, Attachment 1, Dkt-3300, §§ 4.3.2 and 4.4.2 (12:2461). The remaining assets of the Palco Debtors, one sawmill located in Scotia, California (the "Mill") and related inventory and working capital (the "Mill Working Capital"),[10] are transferred to Newco. In exchange for Marathon's contribution to Newco of $25 million, the Mill, and the Mill Working Capital, Marathon receives a secured note from Newco in the amount of the Mill Working Capital and a 15% equity interest in Newco. *See id.* Using MRC/Marathon's own trial valuation evidence, all the value of the Palco Debtors' assets flows to Marathon and none of that value is used to pay

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[9] $25 million paid by Marathon. Excerpt-H, Attachment 1, Dkt-3300, § 7.1 (12:2468), Dkt-2401, pg. 43 (25:6664).

[10] *See* Excerpt-H, Attachment 1, Dkt-3300 (Appendix A) (12:2487).

Palco's unsecured creditors. Dkt-2795, pg 201:2-3 and 243:1-20; Excerpt-G, Dkt-3088, pg. 6; Dkt-3192 (14:2924); Appellee-143; Appellee-146.

B. Scopac's Encumbered Assets Sold to Newco; Newco Pays Claims Against Scopac and Palco.

As Marathon's witness explained, "Newco is then purchasing the assets of Scopac." Dkt-2795, pg. 197:9-10. All of Scopac's Timberlands and other assets (except for its claims in the Headwaters Litigation[11] and certain other litigation claims) are sold to Newco free and clear of the Indenture Trustee's lien and claims. Excerpt-H, Attachment 1/Dkt-3300, §§ 4.6.2 and 7.1 (12:2462 and 2468). In exchange, Newco (i) pays Noteholders a minimum of $513.6 million[12] of the $740 million owed under the Notes; (ii) after applying Scopac's cash and securities, pays the approximately $37 million in secured claims of lenders to Scopac under a line of credit facility for which Bank of America ("BofA") was the Agent[13]; and (iii) pays *unsecured* administrative, priority and general claims against Scopac and Palco which were estimated to be approximately $10 million and $18 million, respectively (all of which are *junior* to the Noteholder's secured

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[11] *See* Excerpt-H, Attachment 1, Dkt-3330 (Appendix A) (12:2497)

[12] The maximum payment of $530 million to Noteholders is reduced by a complex "Class 6 Distribution Adjustment," estimated to be in excess of $13 million. *See* Excerpt-H, Attachment 1, Dkt-3330, § 4.6.2 and Appendix "A" (definition of "Class 6 Distribution Adjustment") (12:2462 and 2496); Dkt-3192 (14:2924).

[13] The "BofA" claims are *pari passu* with and share the same lien as the Noteholders but are entitled to a payment priority under the Indenture. Appellant-516, pgs. 2-3; Appellant-514, Sec. 7.7.

claims on the Scopac assets being transferred to Newco). Dkt-2401, pgs. 47-51 (25:6668-72).

VI. <u>The Plan's Manipulation of Voting Classes.</u>

The Plan created four separate classes of Scopac creditors for purposes of Plan voting and determining whether the requirements of 11 U.S.C. §§ 1129(a)(8) and 1129(a)(10) were met.

(a) <u>Class 5</u>: Scopac Loan Claims. The Plan provides for the payment in cash of all principal, non-default interest and other fees and charges owed on the approximately $37 million in BofA claims, but artificially "impairs" Class 5 by deferring the payment of a *de minimus* amount of alleged default interest, if any, over a 12 month period. Excerpt-H, Attachment 1, Dkt-3330, § 4.5 (12:2462).[14]

(b) <u>Class 6</u>: Secured Scopac Timber Note Claims. The Plan provides for the payment to the secured Noteholders of cash equal to approximately 70% of the $740 million in Note claims and the retention of any lien on the Headwaters Litigation. Excerpt-H, Attachment 1, Dkt-3330,§ 4.6.2.1 (12:2924).

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[14] No business or economic need or justification was demonstrated for this minimal deferral; indeed, the Indenture Trustee Plan treated such claims as "unimpaired." Dkt. 2774, §§ 3.3 and 3.4 (20:5219 and 5220).

(c) Class 8: Scopac Trade Claims. The Plan provides this class of unsecured claims of (i) former Scopac employees and (ii) national and local trade creditors whom Scopac had not deemed "critical vendors"[15] [Excerpt-H, Attachment 1, Dkt-3330, Appendix A (defining "Scopac Trade Claims")] with an assured cash payment of 75-90% of their claims, plus a ratable interest in a litigation trust. Dkt-2401, pg. 51 (25:6672).

(d) Class 9: Scopac General Unsecured Claims. The Plan provides this class, consisting essentially of the Noteholders' unsecured deficiency claim, with *no* assured cash payment, unlike unsecured Class 8 claims of the same rank and priority, and only an interest in a litigation trust (a distribution the Disclosure Statement estimated as "unknown"). (Dkt-2401, pg. 51) (25:6672).

VII. The Rejection of the Plan by the Overwhelming Majority of Scopac's Creditors.

On February 29, 2008, the Bankruptcy Court approved (i) a Joint Disclosure Statement for all the pending plans [Dkt-2353] and (ii) solicitation procedures providing only 25 days for the solicitation of votes on the plans and scheduling the

[15] Early in its bankruptcy case, Scopac identified and obtained Court approval to pay, pre-petition claims of "critical" vendors. *See* Dkt-208 (52:16352); *see also* Dkt-3085, pg. 99:7-16. Thus, Class 8 consists of "non-critical" vendors.

hearing on confirmation for April 8, 2008 – only 39 days after the disclosure statement was approved. Dkt-2387 (21:7143).

The overwhelming majority of *Scopac* creditors, in both *number* and *amount*, voted to reject the Plan.[16] Nevertheless, based on the vote of (i) $241,382 in voted Class 8 claims that were of the same rank and priority as the over $227,000,000 of Class 9 claims that rejected the Plan, and (ii) the artificially "impaired" Class 5 secured claims, MRC/Marathon sought to confirm their Plan pursuant to the "cramdown" provisions of 11 U.S.C. § 1129(b) over the "no" vote of the holders of approximately $740 million of secured and unsecured claims in Classes 6 and 9. Including the artificially impaired Class 5 claims, less than 5% of the claims against Scopac (by dollar amount) accepted the Plan. If Class 5 is properly viewed as unimpaired, then less than 0.1% of the impaired claims against Scopac accepted the Plan.

VIII. **Confirmation of a Single Bidder Plan Based on the Bankruptcy Court's Opinion of Value.**

The Debtors and the Indenture Trustee objected to confirmation of the Plan. Dkt-2612 and 2614 (21:5398 and 5337). The confirmation hearing was conducted

[16] Class 5 votes to accept every proposed plan.

Class 6 votes to reject the MRC/Marathon Plan (124 of 130) totaled $688,729,517.

Class 8 votes to accept the MRC/Marathon Plan (26 of 27) totaled $241,382.

Class 9 votes to reject the MRC/Marathon Plan (125 of 132) totaled $688,729,517 on their face (over $227 million in deficiency claims per the terms of the MRC Plan). Dkt-2581, Exhibit A, pg. 1.

on April 8-11 and April 29–May 2, 2008, (the "Confirmation Hearing"), with closing argument on May 15. During the Confirmation Hearing, the Debtors withdrew their proposed plans. Dkt-2846 (20:4953).

On June 6, 2008, the Bankruptcy Court issued Findings of Fact and Conclusions of Law (the "Findings") indicating that it would deny confirmation of the Indenture Trustee Plan and confirm the MRC/Marathon Plan if certain amendments were made [Excerpt-G/Dkt-3088, pg. 9, 118 (16:3574, 3683)], including: (1) that the payment to Noteholders on their Class 6 secured claims be no less than $510 million;[17] and (2) that the Indenture Trustee retain its lien on Scopac's claims in certain litigation known as the Headwaters Litigation. Appellant-285, pg. 9. The $510 million "floor" was based on the Bankruptcy Court's finding that the fair market value of the Timberlands was no more than $510 million [Excerpt-G/Dkt-3088, pg. 9, 61 (16:3574, 3626)], a valuation testified to by no expert. Although the Plan also provides for Newco's acquisition of additional collateral securing the Notes, free and clear of liens, the Bankruptcy Court made no finding of the value of that additional collateral; no evidence of that value was offered at the Confirmation Hearing. *See generally* Excerpt-G/Dkt-3088 (16:3574).

[17] Following proceedings on a separate motion by the Indenture Trustee for the allowance of an administrative claim under section 507(b), the Bankruptcy Court increased the required minimum payment to Noteholders to $513.6 million. Excerpt-H, Attachment 1/Dkt-3300, § 4.6.2.1 (12:2924); Dkt-3318, pg. 27:17-28:18.

On July 8, 2008, the Bankruptcy Court entered the Confirmation Order. Dkt-332 (12:2336). This appeal followed. The Appellants unsuccessfully sought a stay pending appeal of the Confirmation Order from the Bankruptcy Court [Dkt-3381 (6:53), Dkt-3383 (6:51)], the District Court and this Court. On July 30, 2008, over the Indenture Trustee's objection that, under the plain language of the Plan, the Effective Date cannot occur while an appeal of the Confirmation Order is pending, MRC/Marathon filed a Notice of Effective Date.[18]

IX. The Lack of Any Market Test or Meaningful Opportunity for Competitive Bidding for Scopac's Encumbered Assets.

Confirmation of the Plan foreclosed the last possibility to maximize the value of Scopac's encumbered assets by permitting the Indenture Trustee or third parties to make competitive bids. Before it filed for bankruptcy, and until virtually the end of the plan confirmation process, Scopac consistently maintained that the Timberlands were worth far more than the debt under the Notes, and had no interest in any potential bid not well in excess of the over $740 million in Note debt. *See* Dkt-1498 (41:12630), Dkt-2208-2210 (Debtors' Plans of Reorganization) (30:8481-8400); Appellant-568, 571, 589, 592 (Debtors' expert reports).

[18] *See* Dkt-3473, Case No. 07-20027; in the United States Bankruptcy Court for the Southern District of Texas, Corpus Christi Division, of which this Court may take judicial notice.

UBS, whom Scopac hired to market the Timberlands in 2004, had received a written expression of interest that year from an MRC affiliate (MRC's CEO was its Managing Partner), which led UBS to conclude that MRC would pay "$600-$760 million for the entire timberlands using these assumptions" – an amount well in excess of the purchase price under the MRC/Marathon Plan. Appellant-505, pg. 3. But Scopac was not interested, and no sale resulted. *Id.*

Scopac did not pursue an asset sale during the first 16 months of its Chapter 11 case,[19] during which, outside of a plan of reorganization, Scopac, as debtor-in-possession (*see* section 1107), was the *only* party that could sell its assets under section 363(b)(i).[20] Moreover, until January 4, 2008, the Debtors alone had the exclusive right to file a plan. Meanwhile, the automatic stay under section 362 prevented the Indenture Trustee from foreclosing on Scopac's encumbered assets and selling them. The Bankruptcy Court stated that it would have denied a motion to lift the automatic stay. Dkt-3248, pg. 76:12-18. Although the Indenture Trustee's financial advisor tried for a time during the bankruptcy to obtain firm bids for the Timberlands, there was no reason for a potential bidder to negotiate

[19] *After* the Bankruptcy Court announced that it was confirming the MRC/Marathon Plan, Scopac finally filed a motion to sell its assets pursuant to 11 U.S.C. § 363 in an auction process – the very thing that the Indenture Trustee had sought for months. Dkt-3174 (14:2998), Dkt-3195 (14:2916). This should have occurred much sooner, but the Indenture Trustee could not force this result; and confirmation of the Plan precluded it.

[20] *See e.g., In re Dow Corning Corp.,* 199 B.R. 896, 900 (Bankr. E.D. Mich. 1996).

with the Indenture Trustee's advisors; the Indenture Trustee could not sell assets that Scopac owned. *See* Appellant-455, pg. 14.

Likewise, under the reorganization plans that were eventually proposed, only the Indenture Trustee Plan provided for competitive bidding for Scopac's assets. But that plan was rejected by the Bankruptcy Court in favor of MRC/Marathon's Plan, which provided only a single "bidder," MRC/Marathon, who together receive 100% of the ownership interest in Scopac's assets, based, not on valuation in the market, but on a value derived solely from expert testimony. *See* Excerpt-H, Attachment 1, Dkt-3330, §§ 4.6.2.1 and 7.6.1 (12:2462 and 2469). No other offers were considered, and the Indenture Trustee was never permitted to credit bid the debt under the Notes and thereby obtain its collateral. *See generally* Dkt-2206 (30:8723); Excerpt-H, Attachment 1, Dkt-3330 (12:2452).

A public bidding process would likely have attracted a higher offer than MRC/Marathon's. At the confirmation hearing, third parties expressed interest in bidding for Scopac's assets at a price substantially greater than that offered by MRC/Marathon, which could have gone even higher at a competitive auction. Dkt-3086, pg. 65:1–67:14; Dkt-3085, pg. 24:7-13. For example, during the Confirmation Hearing, one potential purchaser, Timberstar Operating Partnership L.P., a large timberland owner and operator, filed a "Notice of Interest in Purchasing Timberland Assets" indicating its willingness to offer $600 million for

the Timberlands. Dkt-2904 (18:4470). Separately, Scotia Redwood Foundation ("SRF"), a Noteholder and well-financed buyer, was prepared to submit a $603 million "stalking horse" bid in an auction solely for the Timberlands.[21] Many others might have been interested, but the speed of the confirmation process, uncertainty surrounding the availability of the assets, and absence of an organized auction/bidding procedure precluded any realistic opportunity for them to conduct due diligence and assemble their own bids.

SUMMARY OF ARGUMENT

The Bankruptcy Court described its approach to this case as follows:

> THE COURT: [W]hen you lift exclusivity, it's no holds barred. ***Anybody can steal the company.*** I mean, you've got to do it legally admittedly. You can't do it with bogus appraisals or whatever that means. I agree. There's no question about any of all that. But it's a new game. I mean, it's capitalism at it finest. ***Go be as ruthless as you want to.***

Appellee-135, pg. 39:19-25 (emphasis added).

With this philosophy as the backdrop, the Bankruptcy Court confirmed a plan for Scopac that:

- took value from Noteholders by allowing a hostile acquirer to purchase their collateral at a forced sale at a pre-set price over their objection, without respecting their statutory right to credit bid their secured claims to

[21] *See* Appellant-545 (Amended Binding Term Sheet of SRF); *see also* Appellant-557-560, 564; Appellant-422, pg. 145:9-13 ("I have authority necessary to close the transaction"); Appellant-422, pg. 212:9-11 (the SRF bid is "a binding term sheet"); Dkt-2863, pgs. 273:24 – 274:5 (the SRF bid was not subject to any financing contingencies that were not within SRF's control).

purchase their collateral and without a value-maximizing competitive market auction;

- took *additional* value from Noteholders by diverting millions of dollars in consideration paid for their collateral to pay *junior* unsecured claims against Scopac and Palco; and

- distorted fundamental, well-established principles of bankruptcy law and basic creditor protections and threatens the vitality of the multi-billion dollar asset securitization market.

First, the Plan violated the decades-old "absolute priority" rule because it diverts millions of dollars in consideration paid for Scopac's encumbered assets to pay unsecured creditors of Scopac and its equity holder, Palco, whose rights as to that collateral, as a matter of law, are junior to those of Noteholders. Indeed, the Plan inverted normal priorities by providing for *junior, unsecured* creditors of Scopac and Palco to receive a *greater* percentage of their claims (75% to 90%) than Scopac's *senior secured* creditors (70% of their claims). This structure was illegal - unsecured creditors were entitled to *no* distribution from the value of Scopac's assets until the Noteholders, as lienholders on substantially all of Scopac assets, were fully paid.

Second, the Plan did not satisfy the minimum statutory requirements for confirming a plan over the rejection of a dissenting secured creditor class under the "cramdown" provisions of section 1129(b)(2)(A), and violated the Indenture Trustee's statutory right to credit bid the Noteholders' secured claims in a sale of

its collateral under a plan. Section 1129(a)(2)(A)(ii) specifically applies to sales of collateral free and clear of liens under a plan (as occurs under this Plan) and requires that such sales be subject to a secured creditor's credit bid right under section 363(k) (which the Plan denies). Although the Bankruptcy Court resorted to the more general "indubitable equivalent" standard of section 1129(b)(2)(A)(iii) to confirm the Plan, these general provisions cannot be used to eviscerate the specific provisions of section 1129(b)(2)(A)(ii) to permit a sale free and clear of liens under a plan without permitting a credit bid.

Moreover, the uncontradicted record established that Noteholders were not receiving the "indubitable equivalent" of their interest in their collateral, because: (i) part of the consideration for their collateral was taken to pay *junior, unsecured* creditors of Scopac and Palco, essentially buying their votes to authorize a sale of the Noteholders' collateral; (ii) the Noteholders' liens were stripped from other collateral, including claims and causes of action against third parties, which the Bankruptcy Court did not value; and (iii) the forced sale of the Noteholders' collateral to Newco free and clear of liens at a non-market tested price determined by MRC/Marathon, without allowing credit bidding by the secured creditor or a competitive auction in violation of the Supreme Court's *LaSalle* decision did not provide the "indubitable equivalent" of the Noteholders' right to realize the full value of their collateral under a value-maximizing sale at an auction at which they

could exercise their right to credit bid to protect the bargained-for future "upside" value of their collateral.

Third, the Plan effected an improper *sub rosa* substantive consolidation of Scopac and Palco, without satisfying the requirements for substantive consolidation, by forcing the sale of assets of these two separate estates to Newco, a blended entity that will pay unsecured creditors of both Scopac and Palco, and diverting value from Scopac's assets to pay Palco's unsecured creditors. Moreover, as in substantive consolidation, the Plan improperly eliminated intercompany claims between Scopac and Palco, without any distribution thereon. Similarly, the Plan violated section 1129(a)(9)(A) by failing to provide for the cash payment of Scopac's multi-million dollar administrative priority claim against Palco for post-bankruptcy log deliveries.

For these and the other reasons set forth herein the Bankruptcy Court erred in confirming the Plan.

ARGUMENT AND AUTHORITIES

I. The Plan was not "Fair and Equitable" to the Dissenting Class 6 Secured Claims.

Because the Plan was not accepted by Class 6 (Scopac Timber Note Secured Claims), as required by section 1129(a)(8), it could only be confirmed by resort to the "cramdown" provisions of section 1129(b), which requires that a plan be "fair and equitable" to each dissenting class. "Fair and equitable" treatment of a

dissenting secured creditor class requires that the plan: (i) at a minimum, satisfy the statutory requirements under section 1129(b)(2)(A); and (ii) additionally, satisfy "fair and equitable" standards established through decades of jurisprudence, including the "absolute priority" rule. *See In re Kennedy*, 158 B.R. 589, 599 (Bankr. D.N.J. 1993). The Plan met neither of these requirements.

A. **The Treatment of Class 6 Under the Plan Violated the Absolute Priority Rule.**

It is undisputed that the Indenture Trustee had a lien on substantially all of Scopac's assets, and that no equity existed in those assets to pay unsecured creditors at either Scopac or Palco. Nevertheless, part of the purchase price paid by Newco to acquire Scopac's encumbered assets was Newco's agreement to pay an estimated (i) $10 million in *unsecured* administrative, priority and general claims[22] against Scopac [Dkt-2401, pgs. 47, 51 (25:6668, 6672)]; and (ii) $18 million in *unsecured* administrative, priority and general claims against *Palco*, Scopac's *equity holder*. Dkt-2401, pgs. 47-48, 51 (25:6668-69, 6672). Newco's agreement to pay these amounts to unsecured creditors can only properly be characterized as purchase consideration for the Scopac assets, because the Plan allocated the value of the only assets that Newco acquired from Palco—the Mill and Mill Working Capital—to Marathon, an undersecured creditor of Palco which

[22] The rule that an undersecured creditor cannot be forced to fund payment of unsecured claims from the collateral securing its claim applies even with respect to unsecured administrative and other priority claims. *See In re Flagstaff Foodservice Corp.*, 739 F.2d 73, 75 (2d Cir. 1984); *In re Flagstaff Foodservice Corp.*, 762 F.2d 10, 12 (2d Cir. 1985).

had a first lien on those assets and which received the balance of Palco's assets through their transfer to Townco.

Newco's paying unsecured creditors as purchase consideration for Scopac's assets before the secured creditors are paid in full violated the absolute priority rule. This conclusion follows from the fact that Marathon received *all* of the value attributable to the Palco Debtors' assets, through its receipt of (i) 100% of Townco (to which all assets of the Palco Debtors other than the Mill and the Mill Working Capital are transferred); and (ii) 15% of the equity in Newco and a secured note, in exchange for the Mill and the Mill Working Capital and some cash. Excerpt-H, Attachment 1, Dkt-3330, § 4.4.2 (12:2461). The only other assets to be transferred to Newco under the Plan are the Scopac assets on which the Indenture Trustee has a lien. The Plan identifies no unencumbered assets of Scopac that provide the source of payment for unsecured claims against Scopac or Palco. Further, the Plan contains no mechanism to use Palco's assets to pay Palco's unsecured creditors. Thus, Newco's payment of millions of dollars in *unsecured* claims against Scopac and Palco is necessarily part of the consideration for Newco's purchase of the Indenture Trustee's collateral.

The Plan violates the absolute priority rule, a longstanding requisite for fair and equitable treatment of secured creditors in cramdown plan confirmations, by diverting proceeds of the Noteholders' collateral to pay junior, unsecured claims.

Even worse, the Plan turns the normal rules of absolute priority upside down by providing for *unsecured* creditors of Scopac and Palco to receive a *greater* percentage recovery on their claims (75%-90%) than the *secured* Scopac Noteholders (70%), a result prohibited under long-established principles of "absolute priority." Further, the Bankruptcy Court's conclusion that the Plan's favorable treatment of *Marathon* did not violate the absolute priority rule [*see* Excerpt-G/Dkt-3088, pg. 100 (16:3665)], ignored the violation of "absolute priority" inherent in paying unsecured creditors from proceeds of the Noteholders' collateral when Noteholders will not be paid in full.[23]

The condition that a plan be "fair and equitable" with respect to a dissenting secured creditor class "includes" the requirements of section 1129(b)(2)(A) of the Code (*see* section 1129(b)(2)), but the term "includes" is "not limiting" (section 102(3)). The legislative history of the Code explains that the requirements for "fair and equitable" treatment spelled out in section 1129(b)(2) represent only a "partial codification of the absolute priority rule." H.R. REP. NO. 95-595, at 414 (1977). *See generally In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346, 1352 (5th Cir. 1989) ("[S]ection [1129(b)(2)] merely sets minimal standards that a plan must meet, and does not require that every plan not prohibited be approved.") (internal quotations

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[23] The incompleteness of the Bankruptcy Court's analysis reflects the fact that it simply copied almost verbatim MRC/Marathon's proposed conclusion on this point. *Compare* Excerpt-G/Dkt.3088, pg. 100 *with* Dkt-2919, pg. 84.

omitted). The "fair and equitable" requirement also includes uncodified elements established by decades of case law under the former Bankruptcy Act construing the very same term under the prior Act. *See e.g.*, Kenneth N. Klee, *Cram Down IL,* 64 AM. BANKR. L.J. 229, 230, 234 (1990).

The requirement that a plan be "fair and equitable" has long been interpreted by the courts to incorporate the absolute priority rule – a rule rooted in decades of jurisprudence, *see, e.g., Consol. Rock Prod. Co. v. Du Bois*, 312 U.S. 510, 527-29 (1941), and to require "absolute priority" for secured creditors' claims. *See Mokava Corp. v. Dolan*, 147 F.2d 340, 345 (2d Cir. 1945); *see also In re Day & Meyer, Murray & Young, Inc.*, 93 F.2d 657, 658 (2d Cir. 1938).

The classic formulation of the absolute priority rule comes from Collier, the leading treatise on Chapter X of the former Bankruptcy Act:

> Under the absolute priority rule, a plan is not "fair and equitable" unless it provides participation for claims and interests ***in complete recognition of their strict priorities,*** . . . . [E]ach class in descending rank must receive full and complete compensation for the rights surrendered before the next class may properly participate. ***Thus the principle is applied as between senior and junior secured creditors, [and] between secured creditors and unsecured creditors*** . . . .

6A LAWRENCE P. KING, ET AL., COLLIER ON BANKRUPTCY, ¶ 11.06 at 210-211 (14th ed. rev. 1977) (emphasis added).

The "fair and equitable" requirement under section 1129(b) of the Code requires no less than did the same requirement under former Chapter X.

"When . . . judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see Lindahl v. Office of Personnel Mgmt.*, 470 U.S. 768, 782 n.5 (1985). "[I]f Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications." *Midlantic Nat'l Bank v. N. J. Dep't of Envtl. Protection*, 474 U.S. 494, 501(1986) (citations omitted). Congress evidenced its intent that prior case law interpreting the "fair and equitable" requirement retain vitality by using the same words – "fair and equitable" – in section 1129(b), and by using the "not limiting" term "includes" in section 1129(b)(2). *See* 11 U.S.C. § 102(3).

Thus, section 1129(b) retained the rule that a plan is not "fair and equitable" to a dissenting class of secured creditors if it violates the "absolute priority" rule (as the Plan did here). *See In re Kennedy*, 158 B.R. at 599; *see also In re Lakeside Global II, Ltd.*, 116 B.R. 499, 511 (Bankr. S.D. Tex. 1989) ("The 'fair and equitable' requirement provides for an absolute rule of priority among creditors and stockholders in reorganization plans, placing secured creditors' rights first, those of unsecured next, and subordinating the interests of stockholders.") The

Bankruptcy Court erred as a matter of law by confirming a Plan that denies absolute priority to the Indenture Trustee and permits the payment of unsecured creditors instead.

B. The Treatment of Class 6 Under the Plan Does Not Satisfy the Minimum Requirements for "Fair and Equitable" Treatment Under 11 U.S.C. § 1129(b)(2)(A).

1. A Plan that Provides for a Sale of Collateral Free and Clear of Liens Without Preserving the Secured Creditor's Statutory Credit Bid Right Under Section 363(k) is Not "Fair and Equitable."

The core transaction of the Plan is a purchase by Newco (wholly-owned by MRC and Marathon) of Scopac's encumbered assets, primarily the Timberlands. Section 1129(b)(2)(A)(ii) mandates that, to be treated fairly and equitably in such a sale, a dissenting secured creditor must be given (a) the right to credit bid on the collateral (as provided in section 363(k)), and (b) a lien on all of the sale proceeds.[24] This fundamental right to credit bid "gives the secured creditor protections against attempts to sell the collateral too cheaply; if the secured party thinks the collateral is worth more than the debtor is selling it for, it may effectively bid its debt and take title to the property." 7 LAWRENCE P. KING, ET AL., COLLIER ON BANKRUPTCY ¶ 1129.05[2][b][ii] at 1129-148-49 (15th ed. rev. 2008).

The Bankruptcy Court confirmed the Plan, even though it provided the Noteholders no right to credit bid on their Scopac collateral, on the theory that (1)

[24] The Plan could not satisfy section 1129(b)(2)(A)(i) of the Code because it does not provide for the Indenture Trustee to retain all of its liens.

the Plan called the transaction a "transfer" to Newco rather than a "sale;" (2) Noteholders could not credit bid because they did not avail themselves of the right to make the election under section 1111(b)(2) of the Code; and (3) the court could confirm the Plan despite non-compliance with clause (ii) of section 1129(b)(2)(A) by resorting to the more general "indubitable equivalent" standard in clause (iii). Excerpt-G, Dkt-3088, pgs. 6-7, 113-15 (16:3571-72, 3678-80). Each of these rationales for denying the Noteholders' statutory right to credit bid was wrong as a matter of law.

First, it is clear that the Plan provides for the "sale" of the Noteholders' collateral to Newco; thus, section 1129(b)(2)(A)(ii) applied to the transaction. The Bankruptcy Court's conclusion to the contrary [Excerpt-G, Dkt-3088, pg. 7 (16:3571)] defies the common sense meaning of "sale." A "sale" is "[t]he transfer of property or title for a price. *See* UCC § 2-106(1). BLACK'S LAW DICTIONARY (8th ed. 2004). That is precisely what occurred here: cash in, assets out.[25] Indeed, Marathon's own witness admitted that "Newco is *purchasing* the assets of Scopac." *See* Dkt-2795, pg. 197:4-10 and pgs. 197:22 – 198:5 (emphasis added).

Since this was a sale, the right to credit bid in clause (ii) of section 1129(b)(2)(A) should have applied. This right applies in *any* situation where assets

[25] If, however, the Bankruptcy Court's artifice is to be believed, and the assets were "transferred" to Newco and Towneo in transactions too difficult to trace to constitute a "sale," this only strengthens the Indenture Trustee's argument that the debtors' assets were substantively consolidated. The Plan fails either way.

are to be sold free and clear of liens. *See generally In re Kent Terminal Corp.*, 166 B.R. 555, 566 (Bankr. S.D.N.Y. 1994) (finding that there is "an absolute right to credit bid when collateral is sold under a plan of reorganization"); *see also John Hancock Mut. Life Ins. Co. v. Cal. Hancock, Inc.*, 88 B.R. 226, 231 (B.A.P. 9th Cir. 1988) (credit bid right protects secured creditor's interest "in the full value of the property").

Of the three clauses of section 1129(b)(2)(A), only clause (ii) specifically deals with sales free and clear of liens. It requires that the secured creditor have a right to credit bid and receive a lien on the sale proceeds (if it does not credit bid). While Congress provided that the lien on the sale proceeds can be dealt with, "under clause (i) or (iii) of this subparagraph," section § 1129(b)(2)(A)(ii), it left no option for the sale itself except section 1129(b)(2)(A)(ii), which requires that the dissenting secured creditor be accorded credit bid rights, as provided in Section 363(k). Thus, while the sale *proceeds* can be treated under clause (i) or (iii), the sale itself must *first* proceed through clause (ii) – providing credit bid protection. Hence, the dissenting secured creditor must be accorded the credit bid right, as

provided in Section 363(k), unless the court finds good cause under section 363(k) to deny that right (which was never and could not have been found here).[26]

Second, contrary to the Bankruptcy Court's ruling [*see* Excerpt-G, Dkt-3088, pgs. 114-15 (16:3679-80)], the fact that Noteholders did not "avail themselves" of the right to elect, under Code section 1111(b)(2), to have their claims treated as fully secured, did not eliminate the Indenture Trustee's credit bid right under sections 1129(b)(2)(A)(ii) and 363(k). To begin with, "A class . . . may not elect [under section 1111(b)(2)] if . . . the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan." Section 1111(b)(1)(B). Since the Noteholders have recourse for their claims [Appellant-516, § 8.5(d)] and their collateral "is to be sold under [the] Plan," the section 1111(b) election was not legally available to them. The legislative history of section 1129 explains why:

> Sale of property under section 363 or *under the plan* is excluded from treatment under section 1111(b) *because of the secured party's right to bid in the full amount of his allowed claim at any sale of collateral under section 363(k) of the House amendment.*

S. REP. NO. 95-989, at 127-28 (1978) (emphasis added).

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[26] Cases denying a credit bid right generally involve questions about the validity of the lien underlying the credit bid. *See, e.g., Greenblatt v. Steinberg*, 339 B.R. 458, 463 (N.D. Ill. 2006); *Morgan Stanley Dean Witter Mortgage Capital, Inc. v. Alon USA LP (In re Akard St. Fuels, L.P.)*, No. 3:01-CV-1927-D, 2001 U.S. Dist. LEXIS 21644, at *8–9 (N.D. Tex. Dec. 5, 2001).

Moreover, section 1129(b)(2)(A)(ii) contains no limitation or qualification on the right to credit bid based on section 1111(b), and, indeed, *does not even mention* section 1111(b). Where Congress intended to tie the application of a plan confirmation requirement to section 1111(b), *it did so explicitly*, as it did in section 1129(a)(7)(B) of the Code. Congress' failure to enact a similar limitation in section 1129(b)(2)(A)(ii) demonstrates that none was intended. *See Rush Truck Ctrs. of Tex. L.P. v. Bouchie*, 324 F.3d 780, 784 (5th Cir. 2003). "[W]hen the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms." *Lamie v. United States Tr.*, 540 U.S. 526, 534 (2004).

Third, the Bankruptcy Court's resort to the "indubitable equivalent" standard of section 1129(b)(2)(A)(iii) [*see* Excerpt-G, Dkt-3088, pg. 114 (16:3671)] to avoid the application of the clear "credit bid" requirement of section 1129(b)(2)(A)(ii) to a plan providing for a sale free and clear of liens, conflicts with the structure of section 1129(b)(2)(A) and basic principles of statutory construction. Clause (ii) is the only clause in 1129(b)(2)(A) that refers specifically to sales of collateral under a plan and specifically requires that the dissenting secured creditor receive credit bid protection. Clause (iii) of section 1129(b)(2)(A) is a provision of general application which makes no reference to sales.

The Bankruptcy Court's use of the general provisions of clause (iii) to trump the specific provisions of clause (ii) respecting sales of collateral violates the fundamental principle that "[a] specific provision controls over one of more general application." *Landmark Land Co. v. Office of Thrift Supervision*, 948 F.2d 910, 912 (5th Cir. 1991) (quoting *Gozlon-Peretz v. United States*, 498 U.S. 395 (1991)).[27] It also conflicts with the principle that "a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." *TRW, Inc. v. Andrews*, 534 U.S. 19, 31, (2001). Section 1129(b)(2)(A)(ii) deals *only* with sales free and clear of liens, and nothing else. If section 1129(b)(2)(A)(iii) were read to provide that a plan which provides for a sale free and clear of liens may be "fair and equitable" without including an opportunity to credit bid, section 1129(b)(2)(A)(ii) would become superfluous. Such an interpretation would effectively read section 1129(b)(2)(A)(ii) out of the Code.

[27] Consistent with these principles, courts have held that a more general provision of the Code cannot be used to accomplish a result not contemplated by a more specific provision of the Code. *See In re Combustion Eng'g, Inc.*, 391 F.3d 190, 237 n.50 (3d Cir. 2004) (Bankruptcy Code section 105(a) "cannot be used to achieve a result not contemplated by the more specific provisions of § 524(g), which is the means Congress prescribed for channeling the asbestos liability of a non-debtor."); *see also*, *In re PW, LLC*, No. CC-07-1176-MkKuPa, 2008 Bankr. LEXIS 1934 (B.A.P. 9th Cir. May 30, 2008).

2. The Bankruptcy Court's Determination that the Plan's Treatment of Class 6 Satisfied the "Indubitable Equivalent" Standard of 11 U.S.C. § 1129(b)(2)(A)(iii) was Contrary to the Undisputed Record and the Law.

The term "indubitable equivalent" emerged from Judge Learned Hand's discourse in *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), where the court explained that, "adequate protection [to a secured creditor] must be completely compensatory." *Id.* at 942. This Court has held that this term requires certainty that creditor will receive full value of what it bargained for when it made its contract with the debtor, *i.e.*, the plan treatment must be "completely compensatory." *See B.M. Brite v. Sun Country Dev., Inc.*, 764 F.2d 406, 409 (5th Cir. 1985). The treatment of Class 6 under the Plan failed this standard for four independently dispositive reasons.

First, the Plan strips the Indenture Trustee's lien from its non-Timberland collateral without a finding of value and without providing any additional compensation. The Plan strips liens, not only from the Noteholders' Timberland collateral, but also from all of Scopac's encumbered personal property assets, including tangible personal property and intangible causes of action, accounts

receivable, tax refunds, tax rebates, any other amounts owed to Scopac, and Environmental Obligations with the exception of the Headwaters Litigation.[28]

The Plan Proponents had the burden of proof on "indubitable equivalence"[29] and presented no evidence at the Confirmation Hearing of the value of any collateral other than the Timberlands. *See* Appellee-144. Accordingly, the Bankruptcy Court's finding of value was limited solely to the Timberlands. *See* Excerpt-G/Dkt-3088, pg. 61 (16:3626). Hence, there was no basis for finding "indubitable equivalence" as to any non-Timberland collateral; and the Bankruptcy Court erred in confirming a plan that stripped the Noteholders' lien from that additional collateral without compensation. Indeed, the Bankruptcy Court's approval of such lien-stripping flatly conflicted with its approach in requiring the retention of the Indenture Trustee's lien on Scopac's claims in the Headwaters Litigation where the Court found that insufficient evidence of value of that asset had been presented. [Excerpt-G/Dkt-3088, pg. 62, ¶¶ 225-26 (16:3627).

Second, the Plan divests the Noteholders of the value of their security interest in Scopac's assets by using that value to improperly pay unsecured

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28 *See* Excerpt-H, Attachment 1, Dkt-3330, § 7.6.2 and Appendix A, (definition of "SPC Litigation Trust Assets") (exclusion in clause (v)) (12:2469). Scopac's tangible personal property constitutes "goods," and its claims and causes of action constitute "general intangibles" (and, in the case of accounts receivable, "accounts"), all of which were covered by the Indenture Trustee's security interest. *See* Appellant-516, pgs. 7, 56; CAL. COMM. CODE §§ 9102(2), (41), (44); *In re L & J Anaheim Assocs.*, No. 91-56427, 1993 U.S. App. LEXIS 11669 (9th Cir. Apr. 5, 1993) (proceeds of lawsuit constitute "general intangible").

29 *See Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enters., Ltd., II*, 994 F.2d 1160, 1165 n.26 (5th Cir. 1993).

creditors of Palco and Scopac. Part of the consideration for Newco's acquisition of the Noteholders' collateral is Newco's agreement to pay an estimated $28 million of *unsecured* claims against Scopac and Palco. Dkt-2401, pgs. 47, 48, 51 (25:6668, 6669, 6672). By definition, diverting part of the proceeds of the Noteholders' collateral to pay unsecured creditors deprives Noteholders of "completely compensatory" treatment.

Third, the Plan fails to provide the Indenture Trustee with the full value of its bargain. The Plan provides for a cash payment to the Indenture Trustee of a minimum of $513.6 million. Excerpt-H, Attachment 1/Dkt-3330, § 4.6.2 (13:2762). In contrast, the Indenture Trustee offered evidence that SRF, a well-financed buyer, had made a firm offer of a minimum of $603 million as the opening bid for the Timberlands at an auction and Timberstar Operating Partnership L.P., a large timberland owner and operator, indicated its willingness to offer $600 million for the Timberlands. *See supra,* pg. 17-18. Although no potential bidder is likely to reveal its best offer outside of a competitive bidding process, indications of interest by these other potential bidders suggest that a competitive auction might have produced an even higher sales price.

Fourth, a forced, non-market tested sale of the Indenture Trustee's collateral to a "hostile acquirer" at a price determined by the acquirer, without affording the Indenture Trustee a competitive auction for third party bids or the right to credit

bid its secured claim if it thinks the sales price for its collateral is too low (to protect its right to receive the long-term "upside" value of its collateral), is not "completely compensatory." A hypothetical sale price derived from a testimonial battle of appraisers hired by interested parties whose appraisals ranged from $430 million to over $900 million [*compare* Appellee 144 *with* Appellant-568] is no substitute for a real sale price derived from competitive bidding in a market-based auction or credit bidding by the secured creditor. The Bankruptcy Court itself acknowledged that the appraisal testimony before it was subject to "potential weaknesses in all of the testimony concerning valuation" [*see* Dkt-2863, pg. 281:19-23) and, at a subsequent hearing in a separate proceeding, referenced "the standard joke that MAI means 'made as instructed.'"[30] Dkt-3318, pg. 12:24 – 13:2. From the Noteholders' standpoint, this is no joke.

MRC/Marathon's own words and conduct underscore the serious shortcomings of such an appraiser-driven process (substituting for a market-driven auction with competitive bidding) as a basis for determining a "completely compensatory" sale price for collateral. MRC/Marathon submitted into evidence an appraisal that valued the Timberlands at only *$430 million* [Appellee 144], even as they were offering to pay at least *$530 million* for that property including at least over $28 million to unsecured creditors of Scopac and Palco, and would

[30] "MAI" is a designation awarded by the Appraisal Institute which means "Member Appraisal Institute."

likely have paid even more if subjected to the rigors of a market auction. In fact, MRC's CEO, Sandy Dean, could not even state that MRC would not participate in an auction where the opening bid solely for the Timberlands was $600 million - $170 million more than MRC's appraisal submitted to the Bankruptcy Court. Dkt-2797, pgs. 99:24-100:1. Moreover, a revealing e-mail authored by Mr. Dean a few months before MRC/Marathon filed the first version of their Plan spoke of the "valuation argument" being "muddied" by: "three sets of appraisals, hearings [and using] the whole valuation debate . . . [to] "convince noteholders of the train wreck [that] is coming;" and (with reference to Marathon and the debtor) of a "bogus appraisal." Excerpt-I/Appellant-727, pg. 3.

Such an inherently flawed and manipulable valuation process conflicts with the Supreme Court's strong preference for using markets – rather than judicial valuations – to determine value:

> . . . the best way to determine value is exposure to a market . . .
>
> . . . it was, after all, one of the Code's innovations to narrow the occasions for courts to make valuation judgments . . .

Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. *LaSalle St. P'ship,* 526 U.S. 434, 457 (1998). Indeed, one of MRC/Marathon's own witnesses agreed that omitting an open marketing process is not a very good way of maximizing value and that a "one bidder process" does not "test the market." *See* Dkt-3085, pg. 298:2-4.

In addition to violating indubitable equivalence, this Plan structure also violated the fair and equitable requirement. The Plan deprived the Indenture Trustee of its right to realize the long-term upside value of its collateral on account of (a) its right to credit bid its entire $740 million claim under section 1129(b)(2(A)(ii) and (b) its right to fair and equitable treatment of its $227 million unsecured deficiency claim under section 1129(b)(2)(B).[31] The Plan did so by requiring a single bidder sale under a plan proposed by a creditor of Scopac's equity holder, based on a theoretical finding of value - a structure at odds with the market test requirement of *LaSalle*, in cram down situations.[32]

Although the Bankruptcy Court partially terminated the Debtors' exclusive right to file a plan under section 1121 in January 2008 [Dkt-2004 (31:8859)], the court did so only to a very limited extent and in a manner that did not permit competitive bidding. The court extended the right to file plans only to Marathon, the Committee and the Indenture Trustee, and required those parties to file a plan within less than four weeks. *See id.* This constrained schedule hardly permitted third parties to conduct reasonable due diligence on over 200,000 acres of

[31] Under section 1129(b)(2)(B), this $227 million unsecured claim was entitled to own Scopacs post-reorganization equity before that equity (or Scopacs assets) was owned by anyone with junior rights as to Scopacs assets, such as Marathon, a mere creditor of Scopac's equity owner.

[32] In *La Salle*, the Supreme Court expressed its strong distaste for plans of reorganization in which old equity deprived an undersecured creditor of its lien and its right as an unsecured creditor to own the collateral by using a theoretical valuation of the debtors assets, instead of exposing them to a real market test of value. Here, Marathon, a creditor solely of Palco, proposed a plan under which no credit bidding was allowed; no cash bidding was allowed; no one else was permitted to bid.

regulated timberland or assemble bids, and bore no resemblance to the concept of an auction and competitive bidding process espoused by the Supreme Court in *LaSalle*.

II. **As a Matter of Law, the Plan Provides for an Illegal de facto Substantive Consolidation of the Debtors.**

Scopac and Palco are separate debtors with separate estates, assets and liabilities. The Noteholders are not creditors of Palco. The Scopac Timber Notes were issued on the basis of, and purchased in reliance on, Scopac's maintenance as a separate entity. *See* Dkt-2795, pg. 209:19 – 211:1; pg. 212:17-22; pg. 216:12 – 217:11.

Nevertheless, the Bankruptcy Court wanted any potential plan for Scopac (the owner of valuable and profitable Timberlands) to also solve the problems of Palco (a separate corporation that owned a money-losing mill) (*see, e.g.*, Dkt-2938, pg. 79:9-16 ("But I don't think anybody believes that a court would confirm some other *half plan* over a whole plan that deals with everything . . . .") (emphasis added)) and pressed the Indenture Trustee to mimic the MRC/Marathon Plan, which required the use of Scopac's assets to fund payments to Palco's creditors. *See, e.g.*, Dkt-3318, pg. 14:13-23. The Scopac Noteholders, however, had no obligation to propose a plan for a different debtor, Palco, or to fund payments to Palco's creditors; and the Bankruptcy Court's expressed predisposition to the

contrary led it to confirm a plan that violated basic principles of bankruptcy law and corporate separateness.

Absent substantive consolidation (which was neither expressly sought nor granted here), the Bankruptcy Court was *required* to respect the integrity of Scopac's corporate separateness:

> Limiting the cross-creep of liability by respecting entity separateness is a 'fundamental ground rule [ ].' [citation omitted]. As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness absent compelling circumstances calling equity (and even then only possibly substantive consolidation) into play.

In re Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005).[33] No such "compelling circumstances" were found here. Moreover, a plan that ignores the integrity of each Debtor's separate estate is improper, even if it does not use the phrase "substantive consolidation." *See, e.g., ACC Bondholder Group v. Adelphia Commc'ns Corp., (In re Aldephia Commc'ns Corp.,* 361 B.R. 337, 360 (S.D.N.Y. 2007).

The fact that the estates of Palco and Scopac were being jointly administered for procedural purposes pursuant to Bankruptcy Rule 1015 does not alter this requirement: "[T]he Code forces the recognition ***that each debtor is a separate entity with separate assets and separate obligations to creditors*** . . . . [J]oint

[33] *See* Amicus Brief of American Securitization Forum, Dkt-60, Case No.08-66; in the United States District Court for the Southern District of Texas, Corpus Christi Division, of which this Court may take judicial notice.

administration does not create a substantive consolidation of these debtors." *In re Emdura Corp.*, 121 B.R. 862, 868 (Bankr. D. Colo. 1990) (emphasis added); *see also In re Gregory Rockhouse Ranch*, No. 05-16120, 2007 Bankr. LEXIS 4343, at *2 n.1 (Bankr. D.N.M. Dec. 21, 2007) (joint plan for multiple debtors must still be evaluated as separate plan for each debtor).

The effect of substantively consolidating separate corporate entities is that, "[T]he intercompany claims of the debtor companies are eliminated, the assets of all debtors are treated as common assets and claims of outside creditors against any of the debtors are treated as against the common fund . . . ." *Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966); *see also Eastgroup Props. v. S. Motel Assocs., Ltd.*, 935 F.2d 245, 248 (11th Cir. 1991). Without using the phrase "substantive consolidation" (or any finding of a basis for it), <u>the Plan effects just such a result</u>. As in substantive consolidation, the intercompany claims of the debtor companies are eliminated. Excerpt-H, Attachment 1, Dkt-3330, § 4.10.2 (12:2465). Also, as in substantive consolidation, the Plan uses Scopac's assets to create a "common fund" from which unsecured creditors of Scopac *and* Palco are paid. Under the Plan, some of Palco's assets and virtually all of Scopac's assets will be pooled and sold (or "transferred") to Newco, the consolidated company that will pay unsecured creditors of *both* estates in consideration for the asset

acquisition. *See* Dkt-2795, pg. 204:18-24 (acknowledging that the Plan pools assets of Scopac and the Palco Debtors to pay all the creditors).

The Plan does not specify which estate's assets are being used to pay which estate's creditors – a defect criticized in *Adelphia*. *See In re Adelphia Commc'ns Corp.*, 361 B.R. at 360. However, the record is clear that (i) the value of Palco's assets is being delivered solely to Marathon, its undersecured creditor, and (ii) Newco's payment of millions of dollars to unsecured creditors of *Palco* represents part of the consideration for Newco's acquisition of *Scopac's* assets. *See supra,* pgs. 22-23. Thus, as in substantive consolidation, Scopac's asset value is being used to satisfy unsecured creditors of both Scopac and Palco – a *de facto* pooling of assets and liabilities. The diversion of millions of dollars of consideration being paid by Newco for the acquisition of *Scopac's* assets, to pay unsecured creditors of *Palco*, is precisely the kind of "offensive" use of substantive consolidation that the Third Circuit recently condemned in *Owens Corning*, 419 F.3d at 215. Because the Plan ignored the integrity of Scopac's separate estate to the Noteholders' detriment, it should not have been confirmed. *See In re Adelphia Commc'ns Corp.*, 361 B.R. at 359-60.

Substantive consolidation is an *extraordinary remedy* vitally affecting substantive rights, which, because of the potential inequities caused by the redistribution of value across corporate lines among creditors of different entities,

should rarely be granted. *See In re Owens Corning*, 419 F.3d at 208-09 ("there appears nearly unanimous consensus that [substantive consolidation] is a remedy to be used 'sparingly'"); *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988); *Kheel*, 369 F.2d at 847. Importantly, *merely furthering a reorganization effort is not enough to warrant substantive consolidation. See Augie/Restivo*, 860 F.2d at 520.

It was particularly inappropriate for the Bankruptcy Court to sanction such a blending of assets of Scopac and Palco and use of Scopac's assets to pay Palco's creditors, because extensive measures were taken to insure the integrity of Scopac's separateness as a basis to obtain hundreds of millions of dollars in financing under the Timber Notes. *See supra,* pgs. 6-7. In the aftermath of the Bankruptcy Court's ruling, no debt purchaser can rely on the separateness of its borrower, no matter what the documents say. The Bankruptcy Court's approval of the Plan's blending of assets and liabilities undermines the basic legal concept of corporate separateness that makes securitization possible, and on which Noteholders relied in purchasing the Notes, and poses a serious threat to the multi-billion dollar securitization market. For all these reasons, the Plan should not have been confirmed and must not be permitted to serve as precedent for such inappropriate substantive consolidation.

III. **The Bankruptcy Court Violated 11 U.S.C. § 1129(a)(9)(A) by Confirming a Plan that Fails to Pay Intercompany Administrative Claims in Cash.**

The record reflects that Scopac has an over $11 million dollar *post-petition* claim against Palco (on which the Indenture Trustee has a lien) for unpaid log deliveries which is an administrative claim against Palco's estate under section 503(b), entitled to priority under section 507(a)(2). *See* Dkt-3288, pg. 67:2-11; *see generally In re Transamerican Natural Gas Corp.*, 978 F.2d 1409, 1420 (5th Cir. 1992). Section 1129(a)(9)(A) unambiguously requires, as a condition to confirmation, that the Plan provide for the payment in cash of this administrative claim, absent an agreement to the contrary. *See, e.g.*, *In re Scott Cable Commc'ns, Inc.*, 227 B.R. 596, 600 (Bankr. D. Conn. 1998). The Plan does not provide for this cash payment (and no agreement to the contrary exists here).

The Plan discharges all intercompany claims, with no exception for administrative claims. *See* Excerpt-H, Attachment 1, Dkt-3330, § 4.10.2 (12:2465). Instead of providing for the required cash payment of Scopac's administrative claim against Palco, the Plan treats that claim in a convoluted fashion under the "Class 6 Distribution Adjustment:" It provides that (i) certain deductions from the nominal $530 million payment to Noteholders will be reduced by a "credit" for that administrative claim, *but* (ii) this "credit" will be *reduced* by "any . . . unpaid receivables owed from Scopac to Palco," including *pre-petition*

non-priority unsecured claims of Palco against Scopac. *See id.,* Appendix A (definition of "Class 6 Distribution Amount," clause (c)).

This structure is illegal. Allowing the offset of Palco's *pre-petition* non-priority claims against Scopac's *post-petition* priority administrative claims is improper and in derogation of an administrative creditor's rights under section 1129(a)(9), *see In re Adelphia Commcn's Corp.*, 361 B.R. at 361, and violates the fundamental requirement of "mutuality" that limits the offset of claims in bankruptcy. *See* 11 U.S.C. § 553(a); *In re Dade County Dairies, Inc.*, 474 F. Supp. 438, 440 (S.D. Fla. 1979); *Aargus Polybag Co. v. Commonwealth Edison Co. (In re Aargus Polybag Co.)*, 172 B.R. 586, 592 n.6 (Bankr. N.D. Ill. 1994) (setoff not available "to offset a pre-petition unsecured claim against a post-petition administrative claim."). Thus, Noteholders, who had a lien on Scopac's administrative claims against Palco, were deprived of the code-mandated cash payment of Scopac's administrative claim.

IV. <u>The Separate Classification of Class 8 Claims from Class 9 Claims of Equal Rank and Artificial Impairment of Class 5 Claims Constituted Illegal Gerrymandering and Vitiated the Vote on the Plan.</u>

Section 1129(a)(10) of the Code requires that if a class of claims is "impaired" under the Plan, at least one class of impaired claims must accept the Plan. *See also* 11 U.S.C. § 1124 (addressing "impairment" of claims). This requirement created a potentially insurmountable hurdle for MRC/Marathon,

because the Noteholders hold over 90% of the secured *and* unsecured claims against Scopac, and overwhelmingly rejected the Plan.[34]

So, MRC/Marathon resorted to two artifices. First, they impermissibly gerrymandered the vote by separating the non-priority, general unsecured claims of equal rank against Scopac into two classes: (i) the unsecured Scopac Trade Claims (Class 8), whose 26 (out of 27) votes to accept the MRC/Marathon Plan totaled *$241,382*; and (ii) the Scopac General Unsecured Claims (Class 9), consisting almost exclusively of the Noteholders' unsecured deficiency claims, whose 124 (out of 130) votes to reject the MRC/Marathon Plan totaled $688,729,517 on their face (*over $227 million in deficiency claims* per the terms of the Plan). *See* Dkt-2581 (22:5620). Thus, a creditor class with the *exact same priority* as the Noteholders' unsecured deficiency claims, and representing *less than one-tenth of 1% (0.1%)* of Scopac's general unsecured claims, gave MRC/Marathon a purported impaired accepting class.

Second, while providing for the cash payment to Class 5 secured claims of approximately $37 million in principal, non-default interest and fees and expenses on the Effective Date, MRC/Marathon purported to "impair" Class 5 by

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[34] The vote of *Palco* creditors for the Plan could not satisfy section 1129(a)(10) with respect to a plan for *Scopac*, a different debtor. Although styled a "Joint Plan" for Scopac and the Palco Debtors, the Plan must, as to Scopac, be evaluated as a *separate* plan for Scopac. *See Gregory Rockhouse Ranch*, 2007 Bankr. LEXIS 4343, at *2, n.1 ("[T]he jointly administered plan of reorganization in fact constitutes five separate plans of reorganization."); *In re Eagle Bus Mfg.*, 134 B.R. 584, 601 (Bankr. S.D. Tex. 1991) (evaluating treatment of "Unsecured Claims ***against each estate***") (emphasis added).

"deferring" the payment of a *de minimus* amount of alleged default interest (less than 5% of the total debt) over twelve months. *See* Excerpt-H, Attachment 1/Dkt-3330, § 4.5.2 (12:2462). Without this odd construct, if the Plan paid the entirety of the Class 5 claims in cash on the Effective Date, Class 5 would not have been "impaired," and its vote would not have been counted under section 1129(a)(10). *See* 11 U.S.C. § 1124. No economic or business justification was offered for this "impairment," and none was found by the Bankruptcy Court. *See* Excerpt-G/Dkt-3088, pg. 99 (16:3664). It is not even clear how much, if any, default interest is owed.

The Bankruptcy Court defended the separate classification of general unsecured claims into Class 8 and 9 by noting that Class 8 trade claimants had a "different stake in the future viability of the ongoing business" than Noteholders. *See* Excerpt-G/Dkt-3088, pg. 93 (16:3658) (citing *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274 (5th Cir. 1991)). This finding would be true for *any* deficiency claim and completely undermines the holding in *Greystone* discussed below. The court likewise found that the treatment of Class 5's default interest was not an attempt to "manufacture" an impaired consenting class. Excerpt-G/Dkt-3088, pg. 99 (16:3664). The Bankruptcy Court was incorrect in both respects. Its errors negated the

effectiveness of the eventual Plan vote, because without the vote of these two classes, there was no impaired class of Scopac creditors that accepted the Plan.

Gerrymandering Class 8. In *Greystone*, this Circuit's landmark case regarding gerrymandering, this Court declared: "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan." *Id.* at 1279. Following this lead, other circuits have not hesitated to reverse confirmation orders where an impaired consenting creditor class was manufactured by a gerrymandered separate classification of unsecured claims of equal rank. *See Barakat v. Life Ins. Co. of Va. (In re Barakat)*, 99 F.3d 1520, 1525 (9th Cir. 1996); *Boston Post Rd. Ltd. v. FDIC (In re Boston Post Rd.)*, 21 F.3d 477, 483 (2d Cir. 1994); *Travelers Ins. Co. v. Bryson Props. XVIII (In re Bryson Props.)*, 961 F.2d 496, 502 (4th Cir. 1992); *In re Holywell Corp.*, 913 F.2d 873, 880 (11th Cir. 1990).

In *Greystone*, the Court held that claims sharing common priority and rights against the debtor's estate should generally be placed in the same class; that separate classification may only be undertaken for reasons independent of the desire to secure the vote of an impaired, assenting creditor class, and that proffered business justification for separate classification must be supported by sufficient evidence. 995 F.2d at 1278-81.

Here, in *Greystone*, there was no evidence that Scopac's timber operation, the second biggest in Humboldt County, could not obtain needed trade services if

the Class 8 unsecured creditors did not receive preferential treatment under a plan. *See* Dkt-3085, pg. 131:10 – 133:8. Class 8 includes claims of former employees who have not worked for Scopac for over one year; claims of national vendors who would continue to trade with Scopac even if not treated preferentially; and local "non-critical" trade creditors whose economic well-being requires that they deal with Scopac. *Id.* On this record, no business reason justified the separate classification of Class 8 creditors; it was purely vote-driven.

Artificial Impairment of Class 5. Circuit courts have also refused to permit a plan proponent to artificially "impair" a class in order to satisfy Bankruptcy Code section 1129(a)(10). *See, e.g., In re Combustion Eng'g, Inc.*, 391 F.3d at 243 (reversing and remanding because use of "stub" claims may constitute artificial impairment). "[F]or purposes of 11 U.S.C. § 1129(a)(10), a claim is not impaired if the alteration of rights in question arises solely from the debtor's exercise of discretion." *Windsor on the River Assocs. v. Balcor Real Estate Fin. (In re Windsor on the River Assocs.)*, 7 F.3d 127, 132 (8th Cir. 1993). Here, the Bankruptcy Court found no business justification for the *de minimis* "impairment" of Class 5, and none exists. In fact, because of the Class 6 Distribution Adjustment, this claim would have been paid out of the distributions to the Noteholders rather than being paid by Newco over a 12 month period. By acting in their short-term economic disinterest, it is apparent that MRC/Marathon

voluntarily chose to defer payment of default interest solely to artificially impair Class 5.

In *John Hancock Mut. Life Ins. v. Route 37 Bus. Park*, 987 F.2d 154 (3d Cir. 1993), Judge Alito, explained the evils of class gerrymandering and artificial impairment in language that resonates here:

> The critical confirmation requirements set out in Section 1129(a)(8) (acceptance by all impaired classes) and Section 1129(a)(10) (acceptance by at least one impaired class in the event of a "cram down") would be seriously undermined if a debtor could gerrymander classes. *A debtor could then construct a classification scheme designed to secure approval by an arbitrarily designed class of impaired claims even though the overwhelming sentiment of the impaired creditors was that the proposed reorganization of the debtor would not service any legitimate purpose.* This would lead to abuse of creditors . . . .

Id. at 158. (emphasis added). Just such an "abuse of creditors" (the Noteholders) resulted from the contrived, vote-driven scheme of classification and "impairment" concocted by MRC/Marathon. The Bankruptcy Court erred by condoning this vote-driven scheme to confirm the Plan over the overwhelming rejection by Scopac's creditors.

V. <u>The Record was Inadequate to Overcome the Presumption that the Plan Discriminates Unfairly Against the Noteholders' Unsecured Deficiency Claims in Class 9.</u>

Because Class 9 general unsecured claims (*i.e.*, the Noteholders' deficiency claims) rejected the Plan, MRC/Marathon had the burden to demonstrate, *inter alia*, that the Plan "does not discriminate unfairly" against Class 9. *See* section

§ 1129(b)(1). Even if the separate classification of Class 8 claims and Class 9 claims was appropriate, "a finding that the plan classification scheme is proper does not necessarily resolve the question of unfair discrimination." *In re Mortgage Inv. Co.*, 111 B.R. 604, 614 (Bankr. W.D. Tex. 1990). "[A] dissident class must. . . receive treatment which allocates value to the class consistent with the treatment afforded other classes with similar legal claims." *Id.*

Here, the Plan was "*presumptively* subject to denial of confirmation on the basis of unfair discrimination" because (1) Class 9 is a "dissenting class;" (2) Class 8 claims "are of the same priority" as those in Class 9; and (3) the Plan provides for a "materially lower percentage recovery" for Class 9. *In re Sentry Operating Co. of Tex., Inc.*, 264 B.R. 850, 863-64 (Bankr. S.D. Tex. 2001) (emphasis added). Whereas Class 8 creditors will receive a cash payment of 75%-90% on their claims, as well as a ratable interest in the SPC Litigation Trust, Class 9 unsecured claims will receive *only* their applicable SPC Litigation Trust participation, with *no* guaranteed cash payment, resulting in a recovery estimated as "unknown." Dkt-2401, pg. 51 (25:6672).

Because there is nothing to suggest that "a lower recovery for the dissenting class is consistent with the results that would obtain outside of bankruptcy," the presumption of unfair discrimination resulting from this differential treatment could be overcome only by proof that "a greater recovery for the other class is

offset by contributions from that class to the reorganization." *Sentry Operating Co.*, 264 B.R. at 864. Here, however, MRC/Marathon failed to meet their burden of providing such "proof." *Id.*

The Bankruptcy Court's conclusion that the "different treatment of Class 8 and Class 9 were necessary to the reorganization. . . ." [Excerpt-G/Dkt-3088, pg. 112 (16:3677)] was predicated on the Court's findings that the "goodwill of these trade creditors in Class 8" is "important for the successful future operation of Scopac's business" [Excerpt-G/Dkt-3088, pg. 65, ¶ 242 (16:3630)]; that the creditors in Class 8 are "small, local creditors" [Excerpt-G/Dkt-3088, pg. 65, ¶ 241 (16:3630)] and that, "if the holders of Allowed Scopac Trade Claims do not receive a substantial cash recovery as part of the reorganization, Scopac's operations will suffer." Excerpt-G/Dkt-3088, pg. 65, ¶ 242 (16:3630).

These factual findings – copied almost verbatim from those proposed by MRC/Marathon[35] – were riddled with plain error. First, these findings ignore the fact that after these chapter 11 cases were filed, Scopac obtained court authorization to pay the pre-bankruptcy unsecured claims of vendors that it deemed

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[35] *Compare* Excerpt-G/Dkt-3088, pg. 17, ¶ 39 (16:3582); pgs. 65-66, ¶¶ 241-244 (16:3630-31); pg. 93, § II.C.1 (16:3658); and pg. 99, § II.C.3 (16:3664), *with* Dkt-2919, pg. 14, ¶ 39 (18:4363); pgs. 52-53, ¶¶ 246-249 (18:4401-02); pgs. 77-78, § II.C.1 (18:4426-27); and pg. 83, § II.C.3 (18:4432). The review of factual findings adopted *verbatim* from those proposed by a litigant should be "approach[ed] with greater caution." *McLennan*, 245 F.3d at 409.

"critical". *See* Dkt-3085, pg. 99:11-16; Dkt-208. Thus, by definition, Class 8 consists of the unpaid vendors deemed "non-critical" according to Scopac itself.

Second, these findings ignore the undisputed facts that (i) Class 8 includes *former* employees who no longer render any services to the Debtors and (ii) the Bankruptcy Court had previously *refused* to authorize payment to these former employees just months earlier. Dkt-3085, pg. 133:3-8. There was no *evidence* that these *former* employees are "important for the future operation of Scopac's business."

Third, Class 8 is not limited to "small, local vendors," but also includes *national* vendors who do not require the preferential payment of their pre-petition claims to provide future services for which those vendors will be paid. *See* Dkt-3085, pg. 131:10 – 133:8; *Sentry Operating Co.*, 264 B.R. at 864 ("preferred" unsecured creditor class that included national creditors was overly broad).

Finally, the fiction that absent preferential treatment, "Scopac's operations will suffer" because trade creditors will not continue to do business with it is flatly belied by the acknowledgement of counsel to the Creditors' Committee (the *spokesperson for those creditors* and a co-proponent of the Plan) that the Class 8 trade creditors are "[t]ied to the Company for their livelihood." Dkt-2794, pg. 124:20-25. It is nonsensical to suggest that such vendors will stop doing business with the *second largest* timberland operator in Humboldt County unless given

preferential treatment. *See* Dkt-3085, pg. 132:1-5. This point is reinforced by the uncontradicted testimony of Dr. Barrett, an officer of Scopac, that, "Certainly for those businesses that focus on timberlands and forest management . . . [w]e're a very, very valuable client. We're also a valuable customer for smaller firms for whom our business can represent a significant portion of their revenues." Dkt-3085, pg. 132:18-21.

In light of this uncontroverted evidence, which the Bankruptcy Court's Findings completely ignored, there was no basis to find the offsetting benefit to the reorganization of providing better treatment to Class 8 that was necessary to overcome the presumption of unfair discrimination against Class 9. *See In re Snyder Drug Stores, Inc.*, 307 B.R. 889, 894-95 (Bankr. N.D. Ohio 2004) (finding unfair discrimination against separately classified unsecured claims); *see also Oxford Life Ins. Co. v. Tuscon Self-Storage, Inc.* (*In re Tucson Self-Storage,* Inc.*)*, 166 B.R. 892, 898 (B.A.P. 9th Cir. 1994).

VI. <u>The Third-Party Release and Exculpation Provisions of the Plan are Illegal.</u>

The Plan contains an expansive "Exculpation Clause" which purports to release claims of non-consenting creditors against numerous *non-debtors*, including "officers, directors, professionals, members, agents and employees" of MRC, Marathon and the Committee. *See* Excerpt-H, Attachment 1, Dkt-3330, § 10.3 & Appendix A (defining "Exculpated Parties") (12:2482 and 2491). Having

obtained confirmation of the Plan through the erroneous means set forth above, the Plan Proponents propose to use this overbroad release language to exonerate themselves.

Section 524(e) provides that "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such debt." 11 U.S.C. § 524(e). Courts have repeatedly held that a chapter 11 plan may not release claims of an objecting creditor against a nondebtor, absent specific evidence demonstrating unusual or extraordinary circumstances. *See, e.g.*, *In re Continental Airlines, Inc.*, 203 F.3d 203, 214 (3d Cir. 2000); *Menard-Sanford v. Mabey*, 880 F.2d 694, 702 (4th Cir. 1989); *see also Applewood Chair Co. v. Three Rivers Planning & Dev. Dist.*, 203 F.3d 914, 918 (5th Cir. 2000).[36]

In *Feld v. Zale Corp.*, 62 F.3d 746 (5th Cir. 1995), this Court held that an injunction of third party actions against nondebtors may be permitted, but only under "unusual circumstances," which it identified "as 1) when the nondebtor and the debtor enjoy such an identity of interests that the suit against the nondebtor is essentially a suit against the debtor, and 2) when the third-party action will have an adverse impact on the debtor's ability to accomplish reorganization." *Id.* at 761. Absent such circumstances, "the court *may not* enter an injunction of the third-

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[36] Indeed, the Ninth and Tenth Circuits prohibit such third party releases. *See, e.g.*, *In re Lowenschuss*, 67 F.3d 1394, 1402 (9th Cir. 1995); *Landsing Diversified Props.-II v. First Nat'l Bank & Trust Co. of Tulsa*, 922 F.2d 592, 601 (10th Cir. 1990).

party actions." *Id.* (emphasis added). Although *Zale* arose in the context of a requested injunction relating to a settlement, it has been extended to third-party release provisions in reorganization plans. *See In re Wool Growers Cent. Storage Co.*, 371 B.R. 768, 776 (Bankr. N.D. Tex. 2007).

Here, there was no "identity of interest" between MRC/Marathon and Scopac because neither Marathon nor MRC is a creditor, equity holder, officer or director of Scopac. Marathon is a creditor of Scopac's parent, Palco, and MRC is simply a self-described "hostile acquirer." Dkt-3085, pg. 16:11-16.

Moreover, eliminating the third party release would not have had "an adverse impact on the debtor's ability to accomplish reorganization" because there is no "reorganization" of the "Debtor" – the Plan provides for the *dissolution* of Scopac and the sale of its assets to Newco. Excerpt-H, Attachment 1, Dkt-3330, § 7.9 (12:2471). The Bankruptcy Court could not justifiably conclude that a sale of Scopac's assets to Newco was better for Scopac's creditors than a sale any other third party, since there was no competitive bidding for Scopac's assets.[37] Moreover, the "majority of the affected creditors" (*i.e.*, the Noteholders) categorically *rejected* the Plan. *See In re Wool Growers Cent. Storage Co.*, 371

[37] That MRC/Marathon wanted a forced release of potential third party claims of Noteholders who opposed the Plan hardly qualifies as the kind of "unusual circumstances" that would justify a third party release. Otherwise, third party plan releases would become the norm, instead of the exception, since parties to a plan can always insist that they want involuntary third-party releases as a part of the plan.

B.R. at 777 (setting forth five-part test to evaluate non-consensual third-party releases). It was inappropriate to grant such broad releases in a Plan rejected by such a large majority of creditors.

CONCLUSION AND PRAYER

For the reasons and based on the authorities presented above, this Court should reverse the Confirmation Order to correct the errors therein and award relief by: reinstating the Indenture Trustee's improperly stripped lien on all of its collateral, *see Sun Country Dev, Inc.,* 764 F.2d at 406, 406 n.1, junior to Newco's exit-financing, to secure the unpaid balance of the Notes; ordering Newco to pay the Indenture Trustee $40 million comprised of the $28 million of its collateral paid to junior creditors in violation of the absolute priority rule and the $12 million administrative claim that was improperly extinguished under the plan on which the Indenture Trustee had lien; ordering that the overbroad exculpation and release provisions of the Plan and Confirmation Order be struck and granting such other relief to which the Appellants may be justly entitled.

Dated: August 22, 2008
Houston, Texas

Respectfully submitted,

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DECLARATION OF SERVICE BY FED EX

I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and employed in the City of Houston in Harris County, Texas, over the age of 18 years, not a party to or an interested party in the within action; and that declarant's business address is 1301 McKinney, Suite 5100, Houston, Texas 77010.

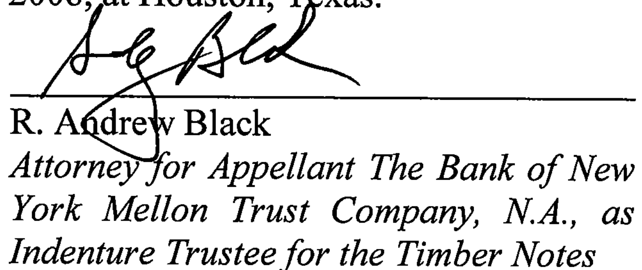
2. That on August 22, 2008, declarant filed **BRIEF OF APPELLANTS THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A., AS INDENTURE TRUSTEE FOR THE TIMBER NOTES; ANGELO GORDON & CO. L.P., AURELIUS CAPITAL MANAGEMENT L.P., AND DAVIDSON KEMPNER CAPITAL MANAGEMENT LLC; AND CSG INVESTMENTS, INC. AND SCOTIA REDWOOD FOUNDATION, INC. and RECORD EXCERPTS** by depositing one original plus nine copies of the brief and one virus-free CD of the brief and one original plus six copies of the record excerpts and one virus-free CD of the record excerpts with the Clerk of the Court by depositing them with FedEx at Houston, Texas in a sealed package with fees thereon fully prepaid for delivery within three calendar days to the Clerk of the United States Court of Appeals for the Fifth Circuit.

3. That, on the same date, declarant served **BRIEF OF APPELLANTS THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A., AS INDENTURE TRUSTEE FOR THE TIMBER NOTES; ANGELO GORDON & CO. L.P., AURELIUS CAPITAL MANAGEMENT L.P., AND DAVIDSON KEMPNER CAPITAL MANAGEMENT LLC; AND CSG INVESTMENTS, INC. AND SCOTIA REDWOOD FOUNDATION, INC. and RECORD EXCERPTS** via electronic mail, per a written agreement, on the parties listed on the attached Service List.

4. That there is regular communication by mail, both written and electronic, between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct.

Executed this 22nd day of August, 2008, at Houston, Texas.



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CERTIFICATE OF SERVICE

In compliance with FED. R. APP. P. 31 and 5TH CIR. R. 31, I certify that, on August 22, 2008, pursuant to a written agreement between the parties, the brief was served on the counsel listed below via electronic mail.

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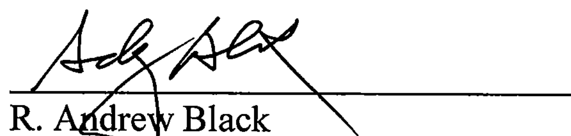
In accordance with FED. R. APP. P. 25(a)(2)(B), I further certify that seven copies of this brief and a diskette containing the brief in PDF format were filed with the clerk of the Court on August 22, 2008, by dispatch for delivery within three calendar days.



R. Andrew Black

CERTIFICATE OF COMPLIANCE

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- ☒ this brief contains 13,964 words, excluding the parts of the brief exempted by FED. R. APP. P. 32(a)(7)(B)(iii), or

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Dated: August 22, 2008.

R. Andrew Black