No. _________

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Bank of New York Mellon Trust Company, N.A. (f/k/a The Bank of New York Trust Company, N.A.), as Indenture Trustee, *et al.*

Appellant-Petitioner,

v.

Marathon Structured Finance Fund L.P., Mendocino Redwood Company LLC, and The Official Committee of Unsecured Creditors,

Appellees-Respondents.

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

PETITION FOR PERMISSION TO APPEAL FILED BY INDENTURE TRUSTEE

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CERTIFICATE OF INTERESTED PERSONS PER FIFTH CIRCUIT LOCAL RULES 26.1.1, 27.4 AND 28.2.1

(1) 08-___________; *The Bank of New York Mellon Trust Company, N.A. (f/k/a The Bank of New York Trust Company, N.A.), as Indenture Trustee vs. Marathon Structured Finance Fund L.P., Mendocino Redwood Company LLC, and The Official Committee of Unsecured Creditors*

(2) The undersigned counsel of record certifies that the following listed persons and entities 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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Appellant - Petitioner	**Counsel:**
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Savings Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999)?

(2) Did the MRC/Marathon Plan violate the "absolute priority rule" when unsecured claims and administrative expenses are to be paid out of the consideration being paid by Newco for Scopac's assets encumbered by the Timber Notes?

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STATEMENT REGARDING JURISDICTION

The Court has jurisdiction to consider this petition to permit direct appeal in this bankruptcy case pursuant to 28 U.S.C. § 158(d) and Rule 5 of the Federal Rules of Appellate Procedure. The Bankruptcy Court entered its Order Granting Petition for Direct Appeal to the Fifth Circuit Court of Appeals [Dkt. No. 3382] on July 15, 2008. App. Tab 4 ("Certification Order"). This Petition is made within ten (10) days of entry of the Certification Order.

The Bank of New York Mellon Trust Company, N.A. (f/k/a The Bank of New York Trust Company, N.A.), as Indenture Trustee for the Timber Notes (the "Indenture Trustee"), files this Petition for Permission to Appeal Pursuant to 28 U.S.C. § 158(d)(2) and Federal Rule of Appellate Procedure 5 (the "Request") relating to the Bankruptcy Court's Judgment and Order (I) Confirming 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, (II) Denying Confirmation of the Indenture Trustee Plan, (III) Denying Motion to Appoint a Chapter 11 Trustee (the "Confirmation Order") [Dkt. No. 3302]. App. Tab 2 (related Findings of Fact and Conclusions Law [Dkt. No. 3088] App. Tab 1).

STATEMENT REGARDING POTENTIAL REQUEST FOR EMERGENCY STAY RELIEF

On July 15, 2008, the Bankruptcy Court entered orders certifying the appeal of the Confirmation Order to this Court, but denying the Indenture Trustee's request for stay pending the appeal. *See* App. Tabs 4 and 5, respectively. While the Bankruptcy Court did impose a limited 10–day interim stay to facilitate appeal–related filings, that stay apparently expires after Thursday, July 24, 2008. The Petitioner Indenture Trustee filed an emergency stay motion and briefing with the District Court requesting a stay for the duration of the appeals.

At approximately 5:00 p.m. on July 21, 2008, the District Court declined to exercise jurisdiction over Petitioner's emergency stay motion out of deference to this Court's jurisdiction in connection with a direct appeal petition such as this. Consequently, Petitioner Indenture Trustee will, by separate pleadings filed hereafter, immediately petition this Honorable Court for stay relief on an emergency basis. If such relief is not obtained, the Confirmation Order will go into effect and much of the Indenture Trustee's appeal may be rendered equitably moot insofar as, *inter alia*, the unique California redwood timberlands at issue in this case — and which serve as the Indenture Trustee's collateral — will be immediately sold away.

As the Bankruptcy Court itself noted in Findings and Conclusions relative to its order granting the Indenture Trustee's motion to certify for direct appeal, the challenged "Confirmation Order adjudicates issues of mammoth public importance." App. Tab 3 p.22 ¶51. The Indenture Trustee agrees. So significant is the present case, that Senator Dianne Feinstein, U.S. Representative Mike Thompson, California's Governor and amicus curiae The American Securitization Forum have all written or appeared in the underlying case to express their views on the public interest and novel legal issues. *See, e.g., id.* This level of public interest is indicative of the significance of this appeal.

This Confirmation Order is of national significance not only because it dictates the future of hundreds of thousands of acres of unique California redwood timberland, but also because this unfortunate precedent will create great uncertainty and potential instability in the credit markets. Further, the Indenture Trustee respectfully submits that the Bankruptcy Court's rulings on important, complex legal issues ultimately contravene basic bankruptcy principles, express statutory enactments, generations of common-law, and long-settled debtor/creditor expectations. Left unreviewed by this Court, those legal rulings create great uncertainty in the law and in the capital markets and will only hinder and delay the resolution of this immensely complex bankruptcy case.

I. Facts Necessary to Understand the Questions Presented

The Indenture Trustee disagrees in many respects with the Bankruptcy Court's Confirmation Order, but generally does not dispute its basic recitation of the pre–bankruptcy background facts. Therefore, without waiver or prejudice, please refer to the Bankruptcy Court's June 6, 2008 Findings and Conclusions for a detailed background of this case. App. Tab 1. Core facts relevant to this petition are set out below.

A. Genesis of the Separate Scopac and Palco Debtors

In 1998, Scotia Pacific Company LLC ("Scopac") was established as a separate special purpose company to take ownership of the timberland holdings of The Pacific Lumber Company ("Palco") and certain other affiliated companies to facilitate the issuance of certain collateralized notes (the "Timber Notes"). This approach of creating a separate corporate entity was employed to obtain financing on terms and conditions that would otherwise not have been available had the timber assets remained combined with those of Palco in a single entity. Because the capital markets relied on the corporate separateness of Scopac, its credit ratings reflected significantly higher credit quality.

B. Scopac Issues Nearly A Billion Dollars In Timber Notes

After Scopac was formed, it issued Timber Notes in the initial aggregate principal amount of approximately $870 million, secured by essentially all of

Scopac's assets, including its real estate and timber. Approximately $714 million in principal and $26 million in interest (*i.e.*, a total of $740 million) was outstanding on the Timber Notes as of the Petition Date. The Bank of New York Mellon Trust Company, N.A. (f/k/a The Bank of New York Trust Company, N.A.) serves as the Indenture Trustee and Collateral Agent for the holders of the Timber Notes (the "Timber Noteholders").

C. The Debtors File Separate Bankruptcies

In early 2007, Scopac, Palco, Scotia Development Company LLC, Britt, Salmon Creek LLC and Scotia Inn Inc. (collectively the "Debtors") each filed a voluntary petition for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code").[1] Various groups submitted reorganization plans including the Indenture Trustee, Mendocino Redwood Company, LLC ("MRC") and Marathon Structured Finance Fund L.P. ("Marathon").

While the competing reorganization plans were pending confirmation, Scotia Redwood Foundation, a well-financed buyer, offered to purchase the Scopac timberlands for a minimum bid of $603 million in cash.

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[1] These separate chapter 11 cases were jointly administered but never substantively consolidated pre–confirmation.

D. The Bankruptcy Court Eschews Competitive Bidding on the Timberlands and, Instead, Approves a Single, Integrated Reorganization Plan for the Two Separate Estates

In June 2008, the Bankruptcy Court entered its Findings of Fact and Conclusions of Law Regarding (a) Confirmation of MRC/Marathon Plan (b) Denial of Confirmation of the Indenture Trustee Plan and (c) Denial of the Motion to Appoint a Chapter 11 Trustee (the "Findings and Conclusions") [Dkt. No. 3088], App. Tab 1. Therein, the Court stated that it would sign an order confirming the MRC/Marathon Plan if its proponents would make amendments to the Plan and their proposed confirmation order. The Court would allow $510 million to satisfy the Timber Notes — substantially less than the $603 million Scotia Redwood Foundation had offered for the timberlands. *Id.* Findings and Conclusions App. Tab 1 p. 9 (first full paragraph). After hearings and plan amendments (albeit without any resolicitation of votes), the Bankruptcy Court entered the Confirmation Order on the amended MRC/Marathon Plan. That Plan is an integrated and symbiotic plan that effectively merges the assets of the separate Scopac and Palco Debtor estates with payouts to creditors coming from the single, combined collection of assets.

II. <u>Reasons The Direct Appeal Should Be Allowed</u>

Recent amendments to 28 U.S.C. § 158(d), provide for a direct appeal to the Court of Appeals from a bankruptcy court if the bankruptcy court or district court

certifies that either (i) the order involves a question of law as to which there is no controlling decision or involves a matter of public importance; or (ii) the order involves a question of law requiring resolution of conflicting decisions; or (iii) an immediate appeal from the order may materially advance the progress of the case. 28 U.S.C. § 158(d)(2)(A).

While only one of the three circumstances under Section 158(d) must be present to mandate certification, the Bankruptcy Court expressly found that two of these circumstances are present here — (i) the existence of matters of "mammoth public importance", and (ii) the reality that immediate appeal will materially advance the progress of the Debtors' reorganizations. App. Tab 3 pp. 21–25. The Indenture Trustee submits that, in fact, ***all three independent bases for certification are satisfied*** because the Confirmation Order also turns on important questions of bankruptcy law as to which there is no controlling decision from this Circuit or the Supreme Court.

A. Matters of Massive Public Importance are Involved Here

As shown below, the MRC/Marathon Plan eviscerates the corporate separateness of Scopac from the Palco Debtors by consolidating the two entities for purposes of ***paying Palco creditors with value extracted/stripped from Scopac***. This decision will make it more difficult for companies to obtain financing on favorable terms because of the risk that even a healthy company might be infected

by an ailing affiliate through *de facto* substantive consolidation, regardless if attempts are made to keep the entities entirely separate. Because this radical decision could have damaging effects on borrowers and the credit markets generally, it presents an issue of significant public importance. The appearance and participation of amicus curiae The American Securitization Forum underscores the tremendous impact of this case. If the Bankruptcy Court's decision remains untested and unexplained by a full appeal, it will jeopardize a prevalent form of commercial financing.

The Confirmation Order also has numerous other impacts on the public. The fact that several high–ranking government officials (two members of Congress and California's Governor) have voiced their concern regarding the Debtors' reorganizations is indicative of the public importance of the Confirmation Order. As the Bankruptcy Court opined, it will affect "the economies of Humboldt County, the town of Scotia, California and the State of California, the preservation and maintenance of one of the nation's most ecologically diverse forests, greenhouse gas reduction effects, and a host of other ancillary environmental concerns." App. Tab 3 p. 22 ¶ 51. This Court should grant permission for direct appeal.

B. This Case Presents Complex, Important, and Timely Legal Issues Deserving of More Extensive Treatment than that Afforded by the Bankruptcy Court

The central legal issues raised in this appeal involve novel questions that have not yet been definitively addressed by the Fifth Circuit or the U.S. Supreme Court. The following subset of statutory interpretation issues in particular should be resolved by this Court, and alone provide justification for accepting this case:

> (1) Was the Bankruptcy Court obliged to provide the Indenture Trustee, as a secured creditor, with a right to "credit bid" on the collateral under the provisions of the Bankruptcy Code and the opportunity to subject the Timberlands collateral to a "market test" of value as envisioned by the Supreme Court in *Bank of Am. Nat'l Trust & Savings Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999)?

The claims of secured creditors who, like the Timber Noteholders, have not vote to accept from a plan of reorganization, are given special treatment under the Code to ensure that they receive "fair and equitable treatment." *See* 11 U.S.C. §1129(b)(2).[2] The MRC/Marathon Plan provided that the Timber Noteholders would receive cash in exchange for their collateral interest in the Timberlands as part of MRC/Marathon's purchase of the Timberlands. However, that plan did not provide for any right for the Timber Noteholders to bid on the collateral. The question of whether secured creditors must receive credit bid rights to ensure "fair

[2] Section 1129 provides three options for treatment of secured creditor claims: (1) that the secured creditors retain a lien in the property until such time as they are paid the full value of the claim; (2) a sale of the secured creditor's collateral, such that liens would attach to the proceeds of such a sale (subject to the creditor's right to credit bid on the collateral); or (3) provide the "indubitable equivalent" of its secured claims. *See* 11 U.S.C. § 1129(b)(2)(A).

and equitable" treatment whenever the property is sold free and clear of any liens is an issue of statutory construction that is of vital importance in resolving complex bankruptcies. It has not yet been resolved in this Circuit.

> (2) Did the MRC/Marathon Plan violate the "absolute priority rule" when unsecured claims and administrative expenses of both Scopac and Palco are to be satisfied out of the consideration being paid by Newco for Scopac's assets that constitute collateral for the Timber Notes?

Courts have long recognized that the "fair and equitable" requirement incorporates the absolute priority rule. *See, e.g., Consol. Rock Prod. Co. v. Du Bois*, 312 U.S. 510, 527-29 (1941) (stating that under the absolute priority rule, secured creditors "***must receive . . . compensation for the senior rights which they are to surrender.***") (emphasis added); *Mokava Corp. v. Dolan*, 147 F.2d 340, 345 (2d Cir. 1945). The Bankruptcy Court erred in confirming the MRC/Marathon Plan as it plainly violates the absolute priority rule by diverting a portion of the value of the Timberlands and the proceeds of the sale of the Scopac Timber Noteholders' collateral to pay unsecured claims and administrative expenses against Scopac and against Palco, its equity holder. If this fundamentally flawed paradigm is to be stopped from spreading to other bankruptcy proceedings, it can only be through definitive ruling from this Court.

(3) Does the MRC/Marathon Plan effectuate an improper, *de facto* substantive consolidation of the Debtors?

Under the MRC/Marathon Plan, the assets of Scopac will be pooled with the assets of Palco, and the pooled assets will then be used to pay creditors of both estates without any attempt to identify which estate's assets are being used to pay which estate's creditors. Meanwhile, intercompany claims will be eliminated. This effectively constitutes substantive consolidation, which, because of potential inequities caused by the redistribution of value among creditors of consolidated entities, is only rarely allowed in other circuits. *See In re Owens Corning*, 419 F.3d 195, 208-09 (3d Cir. 2005); *Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966). Direct appeal is necessary to permit this Court an opportunity to determine whether to adopt the *Owens Corning* rationale on substantive consolidation.

C. An Immediate Appeal Would Materially Advance the Chapter 11 Cases

In its order granting certification for direct appeal, the Bankruptcy Court correctly observed that "an immediate appeal from the Confirmation Order will materially advance the progress of the debtors' cases" and that "[t]he debtors and the creditors, including the Indenture Trustee, all deserve the finality of either realizing the debtors' rehabilitation, reorganization and/or liquidation in accordance with the principles of the Bankruptcy Code." App. Tab 3 p. 22 ¶52.

The Indenture Trustee agrees. It is evident, given the importance of the issues and the value of the property at stake, that the parties need to pursue an appeal before this Court. Further, there is no utility to be gained through delay; unlike a bankruptcy court, the District Court does not necessarily have any greater expertise in considering bankruptcy issues than this Court. And because the District Court will not be engaging in fact-finding, its particular strengths relative to an appellate court will not be highlighted. In sum, "the Indenture Trustee's request for direct certification should be granted so that the parties can gain closure regarding the Confirmation Order." *Id.* at 23. This Court should grant permission for direct appeal and intervene now.

III. <u>Relief Requested</u>

This Court should note that the Indenture Trustee will ask this Court to reverse the Confirmation Order. Additionally, because the Indenture Trustee was unable to obtain needed stay–pending–appeal relief from the District Court, it will move for emergency relief in this Court immediately after the filing of this Petition in order to obtain a stay pending appeal no later than Thursday, July 24, 2008 — after which the Bankruptcy Court's interim stay apparently expires. The Indenture Trustee will also request such other and further relief to which it may be entitled whether at law or equity.

CONCLUSION & PRAYER

WHEREFORE, PREMISES CONSIDERED, Appellant–Petitioner the Indenture Trustee respectfully requests that this Court (i) grant the Indenture Trustee's request for permission for direct appeal; and (ii) grant such further relief as the Indenture Trustee may be entitled, either in law or equity.

Dated: July 22, 2008
Houston, TX

Respectfully submitted,

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PROOF OF SERVICE

I certify that copies of this petition were served today by e–mail and Federal Express mail, on July 22, 2008, on the persons named below. Pursuant to Fifth Circuit Rule 27.3, the petition was served on all parties at the same time it was filed with the Court, and all such persons agreed to service of the document and all appended items by electronic means

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Appendices **Tabs**

Findings of Fact and Conclusions of Law Regarding (a) Confirmation of MRC/Marathon Plan; (B) Denial of Confirmation of the Indenture Trustee Plan and (C) Denial of the Motion to Appoint a Chapter 11 Trustee [Dkt. No. 3088] entered June 6, 2008 1

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