No. 08–40746

# IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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

v.

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

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

# APPELLANTS' REPLY BRIEF


**FULBRIGHT & JAWORSKI L.L.P.**

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

**FULBRIGHT & JAWORSKI L.L.P.**

Zack A. Clement (SBTX 04361550)
William R. Greendyke (SBTX 08390450)
R. Andrew Black (SBTX 02375110)
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
Telephone: (713) 651-5151
Facsimile: (713) 651-5246

**ROBBINS, RUSSELL, ENGLERT, ORSECK, UNTEREINER & SAUBER LLP**

Roy T. Englert, Jr. (D.C. Bar 358464)
Mark T. Stancil (D.C. Bar 479012)
1801 K St., N.W., Suite 411
Washington, D.C. 20006
Telephone: (202) 775-4500
Facsimile: (202) 775-4510

ATTORNEYS FOR APPELLANT INDENTURE TRUSTEE

**STUTMAN, TREISTER & GLATT P.C.**

Isaac M. Pachulski (Cal. 62337)
Jeffrey H. Davidson (Cal. 73980)
K. John Shaffer (Cal. 15379)
Eric D. Winston (Cal. 202407)
1901 Avenue of the Stars, 12th Floor
Los Angeles, California 90067
Telephone: (310) 228-5600
Facsimile: (310) 228-5788

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

**AKIN GUMP STRAUSS HAUER & FELD LLP**

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

**AKIN GUMP STRAUSS HAUER & FELD LLP**

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

ATTORNEYS FOR CSG INVESTMENTS, INC. AND SCOTIA REDWOOD FOUNDATION, INC.

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## PRELIMINARY STATEMENT

> A plan that is not fair and equitable with respect to an impaired secured creditor ***cannot*** be confirmed on the basis that such inequity is necessary to protect junior creditors. If market conditions are such that an effective plan of reorganization cannot be developed that is fair and equitable to dissenting creditors, [the secured creditor] is entitled to foreclose on its liens.

*In re D & F Constr. Inc.*, 865 F.2d 673, 676 (5th Cir. 1989) (emphasis added).

Here, MRC/Marathon proposed and the Bankruptcy Court confirmed just such a plan. The numerous errors discussed in Appellants' Opening Brief are not "camouflaged efforts to challenge the Bankruptcy Court's well-supported factual finding[s]" (MRC/Marathon Br. 1); rather, they are legal infirmities that flow directly from the structural defects of the Plan, rendering it unconfirmable. To redress the Bankruptcy Court's error, this Court can unwind the Plan or impose other, established remedies that do not require unwinding the Plan.

## I. The Plan Did Not Provide "Fair and Equitable" Treatment Of The Noteholders' Secured Claims.

Section 1129(b)(2)(A) illustrates three ways a plan may be deemed "fair and equitable" with respect to a secured creditor. MRC/Marathon's argument seizes on the third example—"indubitable equivalen[ce]" § 1129(b)(2)(A)(iii) ("Clause iii")—and argues that payment in cash of the *judicially determined* value of the Timberlands constitutes the "indubitable equivalent" of the secured claim. In other words, they insist that the "indubitable equivalent" of a secured claim is simply a

cash payment equal to a judge's assessment of (part of) the collateral's current value without any opportunity to ascertain its market value through a public sale or to take possession through a credit bid.

MRC/Marathon are wrong. A secured creditor cannot be stripped of its lien unless it has been afforded an "opportunity to gain from a future increase in value of the collateral." 124 Cong. Rec. S17421 (1978) (Sen. DeConcini). The forced sale of collateral at a judicially determined price—without the right to credit bid or exposure to the market—cannot satisfy that requirement. That is why Clause ii dictates that, if there is a sale free and clear of liens, the secured creditor may credit bid and thereby swap its secured claim for property it believes to be more valuable than the judicial estimate. And that is why MRC/Marathon have not cited any case supporting the proposition that "cashing out" a secured creditor at a judicial valuation less than the full amount of the debt is the "indubitable equivalent" of its secured claim.

Instead, while acknowledging that "Clauses i, ii, and iii are designed to be equivalents of one another" (at 38), MRC/Marathon claim that Clause ii sheds no light on the meaning of Clause iii because the Plan effectuated a "transfer" of Scopac's assets, not a "sale." That distinction, pivotal to MRC/Marathon's arguments, is illusory: This Plan walks like a sale, swims like a sale, and quacks like a sale.

Nor can MRC/Marathon simply mischaracterize our argument by stating (at 36) that "the Noteholders assert [] that even though the requirements of Clause iii were satisfied, the Plan could not be confirmed as fair and equitable unless it *also* met the requirements of Clause ii." The Noteholders have *never* conceded that the Plan satisfies Clause iii; they have consistently asserted that, because the Plan provides for the *sale* of their collateral, it *must* comply with Clause ii. Moreover, the general indubitable equivalence provisions of Clause iii cannot be used to circumvent the specific provisions of Clause ii governing sales of collateral. *See In re Edgewater Motel, Inc.*, 85 B.R. 989, 998 (Bankr. E.D. Tenn. 1988) ("Treatment which is less favorable than the treatment specified in section 1129(b)(2)(A)(i) and (ii) would not satisfy [Clause iii].") (internal citations omitted).

Every facet of section 1129(b)(2)(A) indicates a secured creditor cannot be stripped of its lien on the basis of judicial valuation of the collateral without an opportunity to participate in future increases in the collateral's value.

### A. The Noteholders' Collateral Was "Sold" Under The Plan.

Under Clause ii, a sale of collateral free and clear of liens *must* allow the lienholder to credit bid. Having conceded that the three clauses of section 1129(b)(2)(A) "are designed to be equivalents of one another" (Br. 38), MRC/Marathon are forced to argue (at 41-43) that the Plan does not constitute a

"sale" of Scopac's assets. But Scopac's assets were sold for consideration, and simply calling it a "transfer" does not make it something other than a sale.

The Bankruptcy Court's characterization of the transaction as a "transfer" is a conclusion of law, which this Court reviews *de novo*. *See In re Lane*, 742 F.2d 1311, 1356 (11th Cir. 1984) (characterization of a transaction is a question of law); *In re Arnold & Baker Farms*, 85 F.3d 1415, 1421 (9th Cir. 1996) ("ultimate conclusion of indubitable equivalence is a question of law which we review *de novo*").

The Plan did not provide for the reorganization of Scopac and the continued ownership by Scopac, or even its creditors, of its assets after the adjustment of its debts and the payment of claims. Rather, Scopac's assets were liquidated at a judicially determined price and title passed, free and clear of the Noteholders' lien, to a direct competitor who supplied the cash. If that is not a "sale," what is?

It is no answer (MRC/Marathon Br. 41) that the Plan calls for the "transfer" of Scopac's assets pursuant to section 1123(a)(5). When property is "transferred" in exchange for cash, that is a sale. Were it otherwise, plan proponents could avoid numerous statutory requirements by labeling a sale a "transfer." And, of course, a "sale" need not be consensual. *See, e.g.*, Black's Law Dictionary 674 (8th ed. 2004) (foreclosure is a legal proceeding "to force a sale"). As one court observed, the Code's sale provisions "have carefully worked-out limitations on sales (such as

requiring that any liens attach to the proceeds of sale and that sales be subject to credit bids)," and "*it would be inappropriate to interpret it in such a way as to ignore the carefully limited powers in Sections 363(f) and 1129(b)(2)(A)(ii).*" *In re Pacific Gas & Electric Co.*, 273 B.R. 795, 815 (Bankr. N.D. Cal. 2002) (emphasis added).

MRC/Marathon's assertion that "[t]he transfer of Scopac's assets to Newco falls squarely within [the statutory] definition" of a transfer (Br. 42 (citing 11 U.S.C. § 101(54)) is beside the point. That a transaction is a transfer does not mean it is not a sale—that is because, while not every transfer is a sale, *every sale is a transfer*. MRC/Marathon offer no authority suggesting that a competitor's payment of a judicially established price to obtain title to assets is *not* a sale.

### B. Because The Noteholders' Collateral Was Sold Under The Plan Without Allowing The Noteholders To Credit Bid, It Cannot Be Deemed "Fair And Equitable" Under Clause ii.

A plan is not "fair and equitable" under Clause ii unless it affords the secured creditor the right to credit bid. 7 Lawrence P. King, *et al.*, Collier on Bankruptcy, 1129.05[2][b][ii], at 1129-148-49 (15th ed. rev. 2008). That right, under which a secured creditor offers to trade its full secured claim in exchange for the collateral, protects against sale of the collateral at a price that is too low—either because a judge has mistakenly undervalued it or because the creditor believes its value will increase. *See* cases cited at Opening Br. 29-30. Clause ii is

"unequivocal" on that point: "if a debtor sells property free and clear of liens and attempts confirmation under the Code's 'cramdown' provisions, a debtor must allow the secured creditor to bid in its lien." *In re Kent Terminal Corp.*, 166 B.R. 555, 567 (Bankr. S.D.N.Y. 1994).[1]

No one contends the Plan satisfies Clause ii: The Plan effects the sale of Scopac's assets free and clear of liens without affording the Noteholders their right to credit bid. Nevertheless, MRC/Marathon suggest that the Noteholders are better off than they would have been had there been a true open-market sale. But that ignores the potential of a sale process to maximize the value of the collateral through genuinely competitive bidding. And the purpose of the credit-bid right guaranteed by Clause ii is to allow the Noteholders to put their money where their mouths are and acquire the Timberlands in exchange for their claim. That right is highly valuable. *See Bank of America National Trust & Savings Association v. 203 North LaSalle St. P'Ship,* 526 U.S. 434, 458 n.28 (1999) ("Congress adopted the view that creditors and equity security holders are very often better judges of . . . their own economic self-interest than courts") (internal quotations and citation omitted); *In re Greystone III Joint Venture*, 995 F.2d 1274, 1284 (5th Cir. 1991)

[1] The cases Appellees cite (at 36 n.19) for the proposition that a court may deny the right to credit bid "for cause" are easily distinguishable, deal with the validity of the underlying lien, or involve nonrecourse creditors, which is not the case here. In the court below, there was no finding, or record support for a finding, of "cause" to deny the Noteholders their right to credit bid.

("It is dubious to suppose that courts will ordinarily possess superior foresight than the creditors themselves concerning the creditors' best interests."), *vacated on reh'g, id.* at 1284.

In sum, the Plan plainly violates the provision of section 1129(b)(2)(A) that specifically describes when a sale of collateral free and clear of liens is "fair and equitable" to a secured creditor. Even if the Plan arguably complies with the more general "indubitable equivalent" requirement in Clause iii—and, as explained below, it does not—the Plan cannot lawfully strip secured creditors of protections they would have received under Clause ii. *See D&F Constr.*, 865 F.2d at 675-76.

### C. Clause iii Cannot Be Used To Circumvent The Requirements Of Clause ii.

To avoid Clause ii, MRC/Marathon argue (at 15-16) that giving the Noteholders the proceeds of the judicially valued sale (or "transfer") is the "indubitable equivalent" of their claims and therefore satisfies section 1129(b)(2)(A)(iii). That transparent attempt to circumvent the requirements of Clause ii fails. Because the Plan provided for the sale of the Noteholders' collateral, the more general provisions of Clause iii could not be used to avoid the specific requirements of Clause ii. Either Clause ii offers the exclusive means for carrying out a sale free and clear of liens, *or* Clause iii is not met because a plan that provides much less than would a sale free and clear of liens is not the indubitable equivalent of a secured creditor's claim.

Principles of statutory construction preclude MRC/Marathon from using Clause iii to render meaningless Clause ii's credit-bid requirement. First, a specific provision controls over one of more general application. *See* Opening Br. 33 & n.27 (citing cases). Clause ii deals explicitly with sales under a plan and specifically prescribes the minimum steps required to satisfy the "fair and equitable" requirement when a secured creditor's collateral is sold free and clear of its lien.

Second, a statute should be construed so that no provision is rendered superfluous. *See* Opening Br. 33 (citing cases). Clause ii deals only with sales free and clear of liens, and nothing else. If Clause iii allowed a sale of collateral free and clear of liens, without an opportunity for a secured creditor to credit bid, Clause ii would be superfluous. *See generally Edgewater*, 85 B.R. at 998.

*In re Criimi Mae, Inc.*, 251 B.R. 796 (Bankr. D. Md. 2000), which Appellees cite (at 37-38), supports Appellants' position. *Criimi Mae* involved the approval of a disclosure statement (not a plan) over a secured creditor's objection that the plan would ultimately be unconfirmable because it proposed to sell the creditor's collateral free and clear without a right to credit bid. Distinguishing *Kent Terminal*, the court noted that the plan in *Criimi Mae* proposed to give the secured creditor the proceeds of the collateral sale *and* a note for the balance of its claim. *See* 251 B.R. at 798-99. More important, *Criimi Mae* noted that the debtor would

be facing a "formidable task" at confirmation to prove the plan satisfied the "indubitable equivalence" standard: "Something is 'dubitable' if it is 'open to doubt or question.' Conversely, something is 'indubitable' if it is without question, or doubt." 251 B.R. at 808 n.12 (internal citations omitted). The substitution of a highly *dubitable* judicial valuation for an auction with credit bidding, or any other market test, is the error at the heart of this case; the *Criimi Mae* court would never have countenanced MRC/Marathon's use of Clause iii.

In any event, the Noteholders did not receive the "indubitable equivalent" of their claim for a distinct, independent reason: The Bankruptcy Court did not value *all* of the Noteholders' collateral that was sold to Newco. Contrary to MRC/Marathon's assertion (at 25) that the Bankruptcy Court found that *all* the non-Timberland collateral was valued at $48.7 million, that purported analysis was based on the testimony of Scopac's CEO in the separate *post-confirmation* contested matter involving the Noteholders' § 507(b) administrative claim. *See* R.128, pg. 26:20-27:11. That analysis related solely to Scopac's *current* assets, not *total* assets. Appellant-739, pgs. 2-3. The Bankruptcy Court received no evidence about the value of Scopac's non-current, non-Timberland assets (*i.e.*, property, plant and equipment, and non-Timberland real property).

### D. There Was No Right Or Obligation To Make A Section 1111(b)(2) Election.

MRC/Marathon's next attempt to avoid the logic of section 1129(b)(2)(A) is to claim that the Noteholders' losses are of their own making because they did not invoke the section 1111(b)(2) election, which *when applicable* allows an undersecured creditor to have its full claim treated as secured. MRC/Marathon contend that, by not making that election, the Noteholders sacrificed their rights to credit bid at a sale under the Plan. There are two holes in MRC/Marathon's theory: Because the collateral was sold under the Plan, the express terms of section 1111(b)(1)(B)(ii) precluded the Noteholders from making the election; and, even if the election were available, there is *nothing* in the statute to suggest that the credit bid right depends on making the election.

"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." 11 U.S.C. § 1111(b)(1)(B) (emphasis added). Since the Noteholders indisputably 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 legally unavailable.[2]

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[2] "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).

Further, the statute imposes *no* obligation to make an 1111(b) election. Clause ii incorporates the credit-bid right of section 363(k) if the collateral is sold free and clear of liens, without any limitation based on—or even any reference to—section 1111(b). Had Congress intended to tie the application of a confirmation requirement to the operation of section 1111(b), it would have done so explicitly, as it did in section 1129(a)(7)(B). *See Kent Terminal*, 166 B.R. at 566-67.

### E. Clause i Offers No Support For Appellees' Position

MRC/Marathon also suggest that the Plan is "fair and equitable" under Clause iii's "indubitable equivalent" prong because the Plan could have accomplished essentially the same thing via Clause i. They claim (Br. 39) that "the Noteholders could have been required [under Clause i] to take a note with a present value of $513.6 million," allegedly eliminating the undersecured portion of their claim.

That is wrong. Clause i does not purport to apply to sales of collateral free and clear of liens. The same statutory-construction principles that forbid reading Clause iii to eliminate the specific mandate of Clause ii's sale provisions also prohibit reading Clause i to make the same end-run. Moreover, because Clause i does not contemplate a sale of the collateral, the 1111(b) election *would* be legally available for an undersecured creditor in a reorganization of Scopac under Clause i.

Thus, before MRC/Marathon could have made good on their hypothetical threat to "give[] the Noteholders a new Note in the amount of $513.6 million and then repa[y] it the day after the Effective Date" (Br. 39 n.20), the Noteholders could have made the 1111(b) election and converted their entire $740 million claim into a secured claim. Accordingly, the best MRC/Marathon could have done under Clause i would have been to issue the Noteholders new debt in the *full* amount of their $740 million claim, secured by the Timberlands and all other collateral (which, fatally, the Bankruptcy Court did not value). And nothing in MRC/Marathon's hypothetical changes the fact that the Plan effected a sale of the Noteholders' collateral, which is squarely governed by Clause ii, not a reorganization of Scopac, which no longer exists. Clause i therefore offers MRC/Marathon no refuge; to the contrary, it reflects section 1129(b)(2)(A)'s coherent scheme to ensure that secured creditors facing a cramdown have the opportunity to participate in future increases in the value of their collateral.

## II. The Noteholders' Unsecured Deficiency Claim Did Not Receive Fair And Equitable Treatment.

Based on the Bankruptcy Court's valuation, the Noteholders had a $226 million unsecured deficiency claim that was not treated fairly and equitably under the absolute priority rule. That rule prevents the cramdown of a plan in which any junior class of claims or equity interests receives or retains any value unless all dissenting classes of senior impaired creditors are paid in full. Here, the

Noteholders' deficiency claim was entitled to any residual value (*i.e.*, the stock of Scopac) before Marathon (the undersecured creditor of Scopac's old equity owner, Palco) could receive or retain any interest in Scopac.

*LaSalle*, 526 U.S. at 457, dictates that old equity cannot use a "new value" plan to take over and own an insolvent debtor utilizing exclusive opportunities free from competition and without the benefit of market valuation. *See also* Collier ¶ 1129.04[c], at 1129-138 ("[t]he principal response to *203 North LaSalle* at the bankruptcy court level has focused on efforts to expose the debtor's equity interests to the market").

Appellees attempt to distinguish *LaSalle* on three erroneous grounds. First, MRC/Marathon argue (at 23) that "the Debtors' shareholders retained no equity in the reorganized entities." But Marathon ***was*** *de facto* old equity due to its undersecured position at Palco, which gave Marathon the right to own Palco, and thus own Palco's 100% equity interest in a "reorganization." Indeed, because Palco was in no meaningful sense of the term "reorganized"—under the Plan it *no longer exists*—the position of Marathon as *de facto* old equity is even clearer.

In that capacity, Marathon proposed a plan that deprived the Noteholders of their right to own the Timberlands. The Plan prohibited any credit bid right and prohibited any party, other than MRC/Marathon, from even making a bid—all while Marathon retained its interest in Palco's assets and acquired an interest in

Newco, which was to own the Timberlands. That process was not the one contemplated in *LaSalle*.

Next, MRC/Marathon argue (at 28) that "lifting exclusivity to allow competing plans would provide the necessary market test." However, that is not what happened here. The Bankruptcy Court terminated exclusivity *solely* as to the Creditors' Committee, the Noteholders, and Marathon—not as to *all* potential interested parties. This limitation severely hampered any true attempt at a market test. *See, e.g.*, R.112, pg. 64:10–69:9.

Finally, MRC/Marathon argue (at 29) that, because "the Timberlands had been thoroughly marketed both before and during the bankruptcy case," the market test required under *LaSalle* was satisfied. However, before the bankruptcy case, and up until the Confirmation Hearing, Scopac maintained that the value of the Timberlands exceeded $1 billion (41:12635). Although no other party believed these values, the Debtors' adherence to this unrealistic position effectively precluded successful marketing efforts.

## III. The Plan Achieved Illicit Goals Through Impermissible *De Facto* Substantive Consolidation.

MRC/Marathon acknowledge (at 43) that substantive consolidation occurs "when the assets and liabilities of separate and distinct entities are combined in a

single pool and treated as if they belong to one entity." That is what happened here.

Under the Plan, MRC/Marathon paid $580 million to Newco, which Newco used to purchase the assets of Scopac and Palco. Newco became the owner of the consolidated Timberland and mill assets. Newco subsequently disbursed $550 million to Scopac's secured and unsecured creditors *and* Palco's unsecured creditors. Excerpt-H, Attachment 1, Dkt-3300, §§ 4.10.2, 7.1, 7.9 (12:2465, 2468, 2471). Additionally, regardless of any mechanism to credit pre-petition intercompany claims (*see* MRC/Marathon Br. 44-45), the Plan's express terms extinguish all intercompany claims (on which the Noteholders had a lien), another hallmark of substantive consolidation.[3]

Substantive consolidation is an "extraordinary remedy" that vitally affects creditors' rights,[4] and its legal requirements were not satisfied here. First, MRC/Marathon made no effort to allocate the $580 million purchase price among the Timberlands, Scopac's other assets, and the mill sold to Newco. Therefore, it is impossible to trace the commingled funds and determine whether the priority schemes of the Bankruptcy Code were followed. Rather, the $580 million was

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[3] *See* Excerpt–H, Attachment 1, Dkt-3302, § 4.10.2 (12:2280); *see also Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966) (in substantive consolidation "intercompany claims of debtor companies are eliminated").

[4] *See* Brief of *Amicus Curiae* American Securitization Forum In Support Of Appellants (filed Aug. 28, 2008), at 5.

used to pay secured and unsecured claims of Scopac and unsecured claims of Palco without regard to the source of funds. *See ACC Bondholder Group v. Adelphia Commc'ns Corp*, 361 B.R. 337, 360 (S.D.N.Y. 2007) (finding substantial possibility of success on *de facto* substantive consolidation argument where "[n]either the Plan nor the Confirmation Order identifies each individual Debtor's assets and liabilities and how they are being distributed pursuant to the Plan").

Appellees argue (at 43) that the Noteholders' receipt of the *judicially determined* "value" of their collateral nullifies any harm from the Plan's substantive consolidation scheme.[5] Payment of non-market value cannot overcome the fact that the Debtors' assets were pooled, intercompany claims were eliminated, liens were stripped, and the lump-sum proceeds of the "sale" were used to pay creditors of *all* the Debtors. This is an improper, offensive use of substantive consolidation. *See In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005).

## IV. The Plan Violated The Absolute Priority Rule.

MRC/Marathon assert (at 31 n.16) that the absolute priority rule does not apply to the Noteholders and, even if it does, it is satisfied once the Noteholders' secured claims are purportedly paid "in full." They add (at 32) that "[t]he funds

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[5] Appellees' argument that the Noteholders do not have standing to contest substantive consolidation because their secured claim was supposedly "paid in full" ignores the Noteholders' $220 million deficiency claim. *See LaSalle*, 526 U.S. at 441-42.

used to pay Scopac's unsecured creditors came from the value infused by MRC and Marathon." Each argument fails.

Decades of case law hold that the absolute priority rule is part of the "fair and equitable" test for confirming cramdown plans. The authorities cited in our Opening Brief (at 25-27) demonstrate that a plan is not "fair and equitable" to a dissenting class of secured creditors if it violates the absolute priority rule. *See also Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) ("the statutory language and the legislative history of § 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized . . . at the time Congress enacted the 1978 Bankruptcy Code").

MRC/Marathon cite (at 31 n.36) *Mercury Cap. Corp. v. Milford Conn. Assocs., L.P.*, 354 B.R. 1 (D. Conn. 2006), for the proposition that the absolute priority rule applies only to unsecured claims. However, the court merely noted there was a question whether secured creditors had standing to assert a violation of section 1129(b)(2)(B)(ii), which expressly applies only to *un*secured claims. *Id.* at 13.

MRC/Marathon contend (at 31) that the Plan need not satisfy the absolute priority rule because the Noteholders purportedly "received cash equal to the maximum amount of their secured claim: $513.6 million." MRC/Marathon's contention is inapposite. If there were unencumbered assets of Scopac available to

fund the payments to unsecured creditors, *or* if no creditor junior to the Noteholders were to receive any value under the Plan, *or* if the entire $740 million owed to the Noteholders (plus postpetition interest) were to be paid, then MRC/Marathon's argument would be meaningful, but those are not the facts here.

It is undisputed that junior unsecured creditors of Scopac *and* unsecured creditors of Palco received payments under the Plan. It is also undisputed that the Noteholders' claims were secured by substantially all of Scopac's assets and that the Noteholders' claims are ***not*** being paid in full. From what source of value, then, were junior unsecured creditors of Scopac and unsecured creditors of Palco paid? The answer is that the value used to pay junior creditors is derived from Scopac's assets (*i.e.*, the Noteholders' collateral), in clear violation of the absolute priority rule.

MRC/Marathon assert (at 32) that the source of these payments was funds invested by MRC/Marathon. But the absolute priority rule pertains to the distribution of property, not the payment source. MRC/Marathon also claim (at 32) that their cash payment of $580 million and Marathon's conversion of $160 million of debt to equity freed "additional value to be paid to creditors." That unsupported statement ignores the following undisputed facts:

- The Noteholders' lien on substantially all of Scopac's assets secured prepetition debt of at least $714 million (53:16809-10);

- Marathon was an undersecured creditor of Palco with a claim of $160 million, Excerpt-G, ¶¶ 2, 6-11;
- Marathon admitted that Palco's assets were worth only $110 million, R.100, pg. 235:17-236:16;
- Under the Plan, Marathon converts its $160 million undersecured claim into (i) equity of Townco, (ii) 15% of the equity of Newco; and (iii) a new note from Newco. Excerpt-H, Attachment 1, Dkt-3300, § 4.4.2 (12:2461). Thus, all of the value attributable to Palco's assets was provided to Marathon. MRC received the other 85% of Newco;
- The $580 million provided to Newco pays: (a) $7.5 million for operational improvements (Excerpt-G ¶29); (b) $513.6 million on account of the Noteholders' secured claim; (c) $37.6 million on account of BofA's secured claim (Appellant-516, pgs. 2-3; Appellant-514, Sec. 7.7); and (d) the remaining $21.3 million on account of Scopac's administrative priority and general unsecured creditors (other than the Noteholders' deficiency claim), and Palco's administrative priority and general unsecured creditors (25:6668-72).

The Plan *necessarily* uses value derived from Scopac's assets to pay creditors with lower priority, even though the Noteholders' claims are not being paid in full. Once Marathon's $160 million debt-to-equity conversion absorbs all of the value of Palco's assets (valued by Marathon at only $110 million), the only remaining source of value is Scopac's assets. Because Scopac's assets, for which MRC/Marathon are paying $580 million, secure $740 million in claims of the Noteholders, and junior creditors of Scopac and creditors of Scopac's sole shareholder are receiving tens of millions of that $580 million, there is an obvious violation of the absolute priority rule.

MRC/Marathon contend (at 32-34) for the first time on appeal that MRC "overpaid" for Scopac's assets and that the Noteholders are not entitled to the overpayment "premium." Yet MRC/Marathon fail to provide *any* record citation establishing that MRC was paying more than the value of any Scopac asset. Indeed, *the Bankruptcy Court never found that MRC overpaid for any Scopac assets*.

This theory is also legally baseless.[6] Whether or not there was an "overpayment premium," the Noteholders are entitled to all of the proceeds of their

[6] There is no contention that Marathon "gifted" a part of its distribution of Palco's assets to unsecured creditors of Scopac and Palco; such "gifting" would nevertheless violate the absolute priority rule. *See In re Armstrong World Indus.*, 432 F.3d 507, 513 (3d Cir. 2005).

collateral, not merely the "value" predicted by a judicial finding. In any event, the Noteholders' unsecured deficiency claim would have been entitled to a *pro rata* share of any such "overpayment premium."

MRC/Marathon cite (at 33) *In re Adelphia Communications Corp.*, 368 B.R. 348 (Bankr. S.D.N.Y. 2007), and *Highfields Cap. v. AXA Fin.*, 939 A.2d 34 (Del. Ch. 2007), for the proposition that the "Noteholders are not entitled to extra distributions as a result of the unique synergies that will be available to MRC." Neither case supports that proposition.

*Highfields* is a Delaware appraisal case addressing how to value stock. It has no relevance in this bankruptcy case involving protection of a secured interest. *See* 939 A.2d at 47. In *Adelphia*, parties with a right of first refusal for items sold to a third party asserted that they had to pay only fair market value, which was undisputedly lower than the contract price. *See* 368 B.R. at 351. The court held that, because the refusal right was measured by a price equal to a *bona fide* offer made to the debtors, fair market value was irrelevant. *Id.* at 351, 357-58. *Adelphia* therefore has no bearing here.

## V. Appellees Failed To Meet Their Burden To Justify Separately Classifying Unsecured Claims With Identical Legal Priorities And Their Artificial Impairment Scheme.

Appellees manufactured two classes of claims against Scopac to attempt to satisfy Code § 1129(a)(10): Class 5 (BofA's fully secured claims) and Class 8

(unsecured claims of non-critical trade creditors and former employees of Scopac). Class 5 is an artificially impaired class, and Class 8 is a classic gerrymandered class that *In re Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991), held improper. *See* Opening Br. 46-51.

### A. The Plan Presents The Classic Case Of Gerrymandered Classifications.

MRC/Marathon assert that there were good business reasons for not classifying approximately $250,000 in general unsecured claims separately from the Noteholders' $200 million-plus of unsecured deficiency claims with equivalent legal priority, other than manufacturing a class (containing less than 0.002% of the unsecured claims against Scopac) that would accept the Plan.

The Bankruptcy Court found that "Holders of Scopac Trade Claims in Class 8 have a different stake in the future viability of the ongoing business than do the" Noteholders, and that trade creditors' goodwill was important to future operations "because there is a limited market in which to obtain these goods and services." Excerpt G-¶¶ 241, 242.

Local trade creditors may have wanted Scopac and Palco reorganized because their businesses were (and are) dependent on Scopac and Palco *as customers*, but that finding does nothing to justify separately classifying such creditors. MRC/Marathon and the Bankruptcy Court had it backwards—Scopac

did not need the local trade creditors to reorganize; rather, the trade creditors needed Scopac.

In fact, MRC/Marathon produced *no* Class 8 creditor to testify that, without preferential payment, they would refuse to provide goods or services to Scopac. Rather, the "evidence" consisted of a self-serving declaration by MRC's CEO about what ***he "believed"*** might happen and about what goods and services Scopac "***may*** be unable to obtain." Appellant 638 at ¶ 103 (emphases added). Such speculation by an interested plan proponent cannot meet MRC/Marathon's burden, *see Greystone*, 995 F.2d at 1279, to prove legitimate business justifications for separate classification.

MRC/Marathon's reliance on *In re Briscoe Enters.*, 994 F.2d 1160 (5th Cir. 1993), is misplaced. *Briscoe* expressly cautioned that the classification of the unusual claims approved there did not announce a general rule in favor of separate classifications: "We emphasize *the narrowness of this holding.* In many bankruptcies, the proffered reasons as in *Greystone* will be insufficient to warrant separate classification." *Id.* at 1167 (emphasis added).

### B. Appellees Fail To Justify The Impairment Of Class 5.

MRC/Marathon contend that the Plan did not artificially impair Class 5 because BofA will receive approximately $1 million in default interest (out of its

approximately $37 million distribution) in 12 monthly installments, rather than immediately.

MRC/Marathon now contend (Br. 50) that "partial deferral of payment to Class 5 reflected a compromise as to its disputed claim to a default rate of interest." But at *no* time did MRC/Marathon contend below that there was a compromise.[7] MRC/Marathon also now argue (Br. 50) that BofA's claim would have been impaired even if the claims were fully paid on the Effective Date, but that argument too was never pressed below (19:4656). Not surprisingly, the Bankruptcy Court made no findings in support of either theory.

MRC/Marathon's reliance (at 49) on *In re Block Shim Development Co.*, 939 F.2d 289 (5th Cir. 1991), is puzzling. *Block Shim* held that a plan that extended the due date of a note and reduced a creditor's recovery was confirmable because the impaired creditors had *accepted* the plan. *Id.* at 291. That case does not even address artificial impairment.

## VI. Appellees Have Failed To Rebut The Strong Presumption That The Plan Discriminates Unfairly Against Class 9.

As explained in our Opening Brief (at 52), a cramdown plan is presumed to discriminate unfairly, in violation of section 1129(b)(1), if any class of claims sharing the same legal priority as another class will receive a materially lower

[7] Had there been a proposed compromise, appropriate findings under Bankruptcy Rule 9019(a) would have been required.

recovery. That strong presumption is overcome only by proof that the preferred class's greater recovery is offset by essential contributions from that class to the reorganization. *Id.* at 52-53.

There is no dispute that the Plan materially discriminates against Class 9: Class 8 general unsecured creditors receive an immediate cash payment representing approximately 75% to 90% of their claims plus a pro rata share of any net recoveries from prosecution of certain litigation; Class 9 general unsecured claims (primarily the Noteholders' unsecured deficiency claims) receive *nothing* other than their pro rata share of any net recoveries from such litigation. *See* Excerpt–H, Attachment 1, Dkt-3302, § 4.9 (12:2280).

Although MRC/Marathon attempt to justify such discrimination for the reasons related to separate classification—that paying off Class 8 creditors is supposedly justified by the contributions they will make to the reorganization—those arguments are unsupported by the record and are inadequate to satisfy the stringent legal standards for discrimination.[8]

MRC/Marathon rely (at 51) on *Ramirez v. Bracher*, 204 F.3d 595 (5th Cir. 2000), and *In re Ambanc La Mesa Ltd. P'ship*, 115 F.3d 650 (9th Cir. 1997), for the proposition that discrimination is "considered fair if it has a reasonable basis, is

[8] Whether or not there are good business justifications for separate classification, the court must determine whether the discriminatory treatment between the separate classes is unfair. *See In re Mortgage Inv. Co.*, 111 B.R. 604, 614 (Bankr. W.D. Tex. 1990).

necessary for the plan, is proposed in good faith, and is reasonable in relation to its rationale." These cases do not discuss whether a chapter 11 plan overcame a presumption of unfair discrimination, and, in any event, articulate a test far more stringent than that suggested by MRC/Marathon.

In *Ramirez*, for example, Judge Benavides's concurring opinion stated that "unfair discrimination" involves a four-part test, including:

> (2) whether the debtor can carry out a plan without the discrimination; [and]
>
> * * *
>
> (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination.

*Ramirez*, 204 F.3d at 598 n.2.

MRC/Marathon's Brief materially misstates factors (2) and (4). Factor (2) is critical because *there is no evidence in the record that MRC/Marathon "can[not] carry out a plan without the discrimination" against Class 9.* MRC/Marathon provided no evidence, independent of MRC's CEO's speculative and self-serving declaration, that preferential treatment of any of the creditors in Class 8 was essential. Even if there were competent evidence to that effect, there was absolutely no evidence that MRC/Marathon lacked the ability to make commensurate payments to Class 9 to eliminate the discrimination.

The Plan likewise fails factor (4), because the *degree* of discrimination (*i.e.*, zero to Class 9 versus at least 75%-90% to similarly situated general unsecured creditors) bears no direct relation to the purported rationale for the discrimination.

## VII. The Exculpation Provision Illegally Releases Third Parties

Appellees rely (at 54-57) on boilerplate findings to argue that the Plan's release of the Noteholders' potential claims against third parties is justified in light of the "substantial consideration" paid and the five-factor test, described *infra*.

They are wrong. Code § 524(e) provides that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." *See Simmons v. Acquisition Corp.*, No. 2:05-CV-169, 2005 U.S. Dist. LEXIS 28419, at *10 (E.D. Tex. Nov. 9, 2005) (Code § 524 prohibited release of plaintiffs' claim against non-debtor holding company).

Expansive exculpation clauses are permissible only in "unusual circumstances," *Feld v. Zale Corp.*, 62 F.3d 746, 761 (5th Cir. 1995), and this Plan fails the five-factor test guiding that inquiry.[9] MRC/Marathon's assertion (Br. 55) that there is "identity of interest" between the released third parties and "the Debtors" misses the point. The question is whether the released parties have an

[9] The factors are: "(1) identity of interest between the debtor and the third-party; (2) substantial contribution of assets to reorganization; (3) release is necessary to the reorganization; (4) majority of affected creditors have overwhelmingly accepted plan treatment; and (5) plan provides payment of all, or substantially all, of affected classes' claims." *In re Wool Growers Central Storage Co.*, 371 B.R. 768, 777 (Bankr. N.D. Tex. 2007).

identity of interest with *Scopac*, and, as explained in our opening brief (at 57), there is no such relationship. Furthermore, MRC/Marathon completely ignore the "critical" fifth factor. *Wool Growers*, 371 B.R. at 778. Far from making "full or almost full payment of the affected claims," *ibid.*, the Plan shorts the Noteholders by more than $220 million.[10]

## VIII. Appropriate Remedies Can Be Imposed

MRC/Marathon assert that it would be unfair, indeed illegal, for this Court to do anything to remedy the impermissible taking of the Noteholders' rights. They argue that the remedies sought by Appellants, which include not just unwinding the plan but also the very kinds of remedies previously approved by this Court (lien re-imposition and cash payments), would amount to impermissible post-consummation modifications of the Plan. In essence, MRC/Marathon's position is that, after a plan is consummated, this Court can grant no relief whatsoever, a position at odds with the many authorities cited by Appellants' Response to the Motion to Dismiss.

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[10] MRC/Marathon cite (at 54) *In re Hilal*, 534 F.3d 498, 501 (5th Cir. 2008), in support of their argument that the Committee and its personnel are entitled to a full release, only excluding gross negligence or willful misconduct. However, *Hilal* provides only that a trustee—not a creditors' committee—cannot be subject to personal liability for damages to the bankruptcy estate (without a finding of gross negligence). *Id.* at 501 (citing *In re Smyth*, 207 F.3d 758, 762 (5th Cir. 2000)).

Although MRC/Marathon purposely made it difficult to unwind the Plan,[11] they can still be made to pay more for the illegal Plan they confirmed and rushed to consummate. This Court could determine the amount of cash necessary to redress the harm to the Noteholders caused by the erroneous consummation of the Plan.

Additionally, based on the authorities cited in the Response to Motion to Dismiss, this Court can direct lien re-imposition, a remedy appropriate for the $226 million of its claim that the Noteholders were not permitted to credit bid to protect their interest in their collateral. This requested relief permits MRC/Marathon to keep what they took pursuant to an illegal plan that they rushed to consummate, but compensates the Noteholders for the substantial economic harm that was inflicted on them. Such a lien can be imposed on terms that will not cause a reasonable likelihood of a default at Newco. As a result, the consolidation of the Debtors' assets into Newco will not be disturbed and third parties not before the Court in this appeal will not be harmed, but the value of the equity owned by

[11] That it is difficult to unwind the Plan does not mean it is impossible. Pending confirmation of a *lawful* plan of reorganization or liquidation, the money Marathon has put in could be returned; the $513 million the Indenture Trustee is holding could also be returned; companies could be formed or reformed to run the discrete assets Palco and Scopac held; and environmental concerns will be protected because federal and state agencies are duty bound to implement their regulatory authorities to that end, as has been recognized by and integrated into the Indenture Trustee's plan, and which likewise could be integrated into any relief directed by the Court. These steps would take effect only until a lawful disposition of Palco's and Scopac's assets occurred.

MRC/Marathon will be subjected to the obligation to pay the Noteholders' restored lien before that equity will bring real economic value to MRC/Marathon.

MRC/Marathon contend (Br. 13, 57-58) that the relief requested by the Noteholders violates section 1127(b) because the Plan cannot be modified after substantial consummation. That assertion lacks merit. As demonstrated in the Noteholders' opposition to Appellees' motion to dismiss, numerous courts of appeals, including this Court in *Sun Country* and *Hilal*, have concluded that relief, including that which necessarily alters the terms of a plan, may be granted notwithstanding a plan's substantial consummation.[12]

[12] The holding of *In re Speciality Equip. Co.*, 3 F.3d 1043 (7th Cir. 1993), that substantial consummation moots any appeal challenging releases contained in a plan of reorganization is contrary to the settled law of this Circuit and others. *See Hilal*, 534 F.3d at 500-01.

Dated: September 15, 2008
Houston, Texas

Respectfully submitted,

**FULBRIGHT & JAWORSKI L.L.P.**

By: William Greendyke

Zack A. Clement (SBTX 04361550)
William R. Greendyke (SBTX 08390450)
R. Andrew Black (SBTX 02375110)
1301 McKinney, Suite 5100
Houston, Texas 77010-3095
Telephone: (713) 651-5151
Facsimile: (713) 651-5246

-and-

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

**ROBBINS, RUSSELL, ENGLERT, ORSECK, UNTEREINER & SAUBER LLP**

By: Roy T. Englert, Jr. by permission WRG

Roy T. Englert, Jr. (D.C. Bar 358464)
Mark T. Stancil (D.C. Bar 479012)
1801 K St., N.W., Suite 411
Washington, D.C. 20006
Telephone: (202) 775-4500
Facsimile: (202) 775-4510

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

**STUTMAN, TREISTER & GLATT P.C.**

By: Isaac M. Pachulski by permission WRG

Isaac M. Pachulski (Cal. 62337)
Jeffrey H. Davidson (Cal. 73980)
K. John Shaffer (Cal. 15379)
Eric D. Winston (Cal. 202407)
1901 Avenue of the Stars, 12th Floor
Los Angeles, California 90067
Telephone: (310) 228-5600
Facsimile: (310) 228-5788

**Counsel for Angelo, Gordon & Co., L.P., Aurelius Capital Management, LP, and Davidson Kempner Capital Management LLC**

**AKIN GUMP STRAUSS HAUER & FELD LLP**

By: Murry B. Cohen by permission WRG

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

-and-

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

**Attorneys for CSG Investments, Inc. and Scotia Redwood Foundation, Inc.**

## CERTIFICATE OF SERVICE

In compliance with FED. R. APP. P. 31 and 5TH CIR. R. 31, I certify that, on September 15, 2008, pursuant to a written agreement between the parties, the Appellants' Reply Brief was served on the counsel listed below via electronic mail.

| | |
|---|---|
| David Neier<br>dneier@winston.com<br>William Brewer<br>wbrewer@winston.com<br>Steven M. Schwartz<br>sschwartz@winston.com<br>Carey D. Schreiber<br>cschreiber@winston.com<br>Winston & Strawn, LLP<br>200 Park Avenue<br>New York, NY 10166<br>*Counsel for Marathon Structured Finance Fund L.P.* | Eric E. Sagerman<br>esagerman@winston.com<br>Winston & Strawn, LLP<br>333 South Grand Avenue<br>Suite 3800<br>Los Angeles, CA 90071<br>*Counsel for Marathon Structured Finance Fund L.P.* |
| John D. Penn<br>pennj@haynesboone.com<br>Haynes & Boone, LLP<br>201 Main Street, Suite 2200<br>Fort Worth, TX 76102<br>*Counsel for Marathon Structured Finance Fund L.P.* | Trey Monsour<br>trey.monsour@haynesboone.com<br>Alan D. Wright<br>alan.wright@haynesboone.com<br>Haynes & Boone, LLP<br>901 Main Street. Suite 3100<br>Dallas, TX 75202<br>*Counsel for Marathon Structured Finance Fund L.P.* |

| | |
|---|---|
| Allan S. Brilliant<br>abrilliant@goodwinprocter.com<br>Brian D. Hail<br>bhail@goodwinprocter.com<br>Craig P. Druehl<br>cdruehl@goodwinprocter.com<br>Stephen M. Wolpert<br>swolpert@goodwinprocter.com<br><br>Goodwin Procter LLP<br>620 Eighth Avenue<br>New York, NY 10018-1405<br>*Counsel for Mendocino Redwood Company LLC* | Patrick Thompson<br>pthompson@goodwinprocter.com<br>Goodwin Procter LLP<br>Three Embarcadero Center<br>24th Floor<br>San Francisco, CA 94111<br>*Counsel for Mendocino Redwood Company LLC* |
| Frederick C. Schafrick<br>fschafrick@goodwinprocter.com<br>Richard M. Wyner<br>rwyner@goodwinprocter.com<br><br>Goodwin Procter LLP<br>901 New York Avenue, NW<br>Washington, DC 20001<br>*Counsel for Mendocino Redwood Company LLC* | Kenneth M. Crane<br>KCrane@perkinscoie.com<br>Peter G. Lawrence<br>PLawrence@perkinscoie.com<br><br>Perkins Coie LLP<br>131 South Dearborn Street<br>Suite 1700<br>Chicago, Illinois<br>*Counsel for Mendocino Redwood Company LLC* |
| Maxim B. Litvak<br>mlitvak@pszjlaw.com<br>John D. Fiero<br>jfiero@pszjlaw.com<br>Kenneth H. Brown<br>kbrown@pszjlaw.com<br>Pachulski Stang Ziehl Young Jones & Weintraub<br>150 California Street, 15th Floor<br>San Francisco, CA 94111-4500<br>*Counsel for The Official Committee of Unsecured Creditors* | Luckey McDowell<br>luckey.mcdowell@bakerbotts.com<br>Jack L. Kinzie<br>jack.kinzie@bakerbotts.com<br>James R. Prince<br>jim.prince@bakerbotts.com<br>Baker Botts LLP<br>2001 Ross Avenue<br>Dallas, TX 75201-2980<br>*Counsel for Scotia Development, et al.* |

| | |
|---|---|
| Shelby A. Jordan<br>sjordan@jhwclaw.com<br>Nathaniel Peter Holzer<br>pholzer@jhwclaw.com<br>Jordan, Hyden, Womble, Culbreth & Holzer, P.C.<br>500 North Shoreline, Suite 900<br>Corpus Christi TX 78471<br>*Counsel for Scotia Development, et al.* | Jeffrey H. Davidson<br>JDavidson@Stutman.com<br>Eric D. Winston<br>EWinston@Stutman.com<br>Isaac M. Pachulski<br>IPachulski@Stutman.com<br>Stutman Treister & Glatt P.C.<br>1901 Avenue of the Stars<br>12th Floor<br>Los Angeles, CA 90067<br>*Counsel for Angelo, Gordon & Co., L.P., Aurelius Capital Management, LP and Davidson Kempner Capital Management, LLC* |
| Alan S. Tenenbaum<br>alan.tenenbaum@usdoj.gov<br>Bradford T. McLane<br>bradford.mclane@usdoj.gov<br>Andy Mergen<br>andy.mergen@usdoj.gov<br>U.S. Dept of Justice Environment & Natural Resources Division<br>Law and Policy Section<br>601 D Street NW, Suite 2121<br>Washington, D.C. 20004<br>*U.S. Dept. of Justice for Federal Wildlife Agencies* | Kathryn A. Coleman<br>KColeman@gibsondunn.com<br>Gibson Dunn & Crutcher LLP<br>200 Park Avenue, 47th Floor<br>New York, NY 10166<br>*Counsel for Scotia Pacific LLC* |
| Aaron G. York<br>AYork@gibsondunn.com<br>Gibson Dunn & Crutcher LLP<br>2100 McKinney Avenue<br>Suite 1100<br>Dallas, TX 75201-6912<br>*Counsel for Scotia Pacific LLC* | Eric J. Fromme<br>EFromme@gibsondunn.com<br>Craig H. Millet<br>cmillet@gibsondunn.com<br>Gibson Dunn & Crutcher LLP<br>3161 Michaelson Drive<br>Irvine, CA 92612<br>*Counsel for Scotia Pacific LLC* |

| | |
|---|---|
| Dana Livingston<br>dlivingston@adjtlaw.com<br>Alexander, Dubose, Jones & Townsend LLP<br>515 Congress Avenue, Suite 2350<br>Austin, TX 78701<br>*Counsel for CSG Investments and Scotia Redwood Foundation Inc.* | Roger D. Townsend<br>rtownsend@adjtlaw.com<br>Alexander, Dubose, Jones & Townsend LLP<br>1844 Harvard Street<br>Houston, TX 77008<br>*Counsel for CSG Investments and Scotia Redwood Foundation Inc.* |
| Charles R. Gibbs<br>cgibbs@akingump.com<br>David F. Staber<br>dstaber@akingump.com<br>J. Carl Cecere<br>ccecere@akingump.com<br>Akin, Gump, Strauss, Hauer & Feld<br>1700 Pacific Avenue, Suite 4100<br>Dallas, TX 75201-4675<br>*Counsel for CSG Investments and Scotia Redwood Foundation Inc.* | Murry B. Cohen<br>mcohen@AkinGump.com<br>Akin, Gump, Strauss, Hauer & Feld<br>1111 Louisiana Street, 44th Floor<br>Houston, TX 77002-5200<br>*Counsel for CSG Investments and Scotia Redwood Foundation Inc.* |
| J. Mark Chevallier<br>mchevallier@mcslaw.com<br>Marc W. Taubenfeld<br>mtaubenfeld@mcslaw.com<br>McGuire, Craddock & Strother<br>500 N. Akard, Suite 3550<br>Dallas, TX 75201<br>*Counsel for American Securitization Forum* | Hugh McDonald<br>humcdonald@tpw.com<br>Thatcher Proffitt & Wood LLP<br>Two World Financial Center<br>New York, NY 10281<br>*Counsel for American Securitization Forum* |

| | |
|---|---|
| Michael W. Neville<br>Michael.Neville@doj.ca.gov<br>Office of the Attorney General<br>455 Golden Gate Avenue<br>Suite 11000<br>San Francisco, CA 94102<br>*Counsel for California State Agencies* | Paul J. Pascuzzi<br>PPascuzzi@ffwplaw.com<br>Steven H. Felderstein<br>sfelderstein@ffwplaw.com<br>Felderstein Fitzgerald Willoughby & Pascuzzi LLP<br>400 Capitol Mall, Suite 1450<br>Sacramento, CA 95814-4434<br>*Counsel for California State Agencies* |
| Evan M. Jones<br>ejones@omm.com<br>Brian M. Metcalf<br>bmetcalf@omm.com<br>Ana Acevedo<br>aacevedo@omm.com<br>Emily R. Culler<br>eculler@omm.com<br>O'Melveny & Myers LLP<br>400 South Hope Street<br>Los Angeles, CA 90071-2899<br>*Counsel for Bank of America* | |

70386032

Oscar Rey Rodriguez

## CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitations of FED. R. APP. P. 32(a)(7)(B) because:

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Dated: September 15, 2008.

Oscar Rey Rodriguez

**DECLARATION OF SERVICE BY FEDEX**

I, the undersigned, declare:

That declarant is and was, at all times herein mentioned, a citizen of the United States and employed in the City of Dallas in Dallas 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 2200 Ross Avenue, Suite 2800, Dallas, Texas 75201.

That on September 15, 2008, declarant filed **REPLY 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.** by depositing one original plus nine copies of the brief and one virus-free CD of the brief with the Clerk of the Court by depositing them with FedEx at Dallas, 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.

That, on the same date, declarant served **REPLY 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.** via electronic mail, per a written agreement, on the parties listed on the attached Service List.

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 15th day of September, 2008, at Dallas, Texas.

Oscar Rey Rodriguez
*Attorney for Appellant The Bank of New York Mellon Trust Company, N.A., as Indenture Trustee for the Timber Notes*