No. 08-________

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.*

Appellants-Petitioners,

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

JOINDER IN EMERGENCY MOTION FOR STAY AND INJUNCTION FILED BY INDENTURE TRUSTEE AND SUPPLEMENTAL MEMORANDUM [Expedited Ruling Requested on or before July 24, 2008]

STUTMAN, TREISTER & GLATT P.C.

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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, et al. 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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[1] Angelo, Gordon & Co. L.P., Aurelius Capital Management, LP, and Davidson Kempner Capital Management LLC collectively filed in the Bankruptcy Court a notice of appeal [Bankr. Ct. Docket No. 3305] from the Confirmation Order separate from that filed by Appellant-Petitioner Indenture Trustee.

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To the Honorable United States Court of Appeals for the Fifth Circuit:

Appellants Angelo, Gordon & Co. L.P., Aurelius Capital Management, LP, and Davidson Kempner Capital Management LLC (collectively, the "Noteholder Appellants") respectfully join in the "Emergency Motion for Stay and Injunction" (the "Stay Motion") [2] submitted by The Bank of New York Mellon Trust Company, N.A., as Indenture Trustee, appellant-petitioner in the above-captioned appeal, requesting that this Court (or any one of its judges) issue a status quo order *on or before July 24, 2008,* including (1) a stay of the Bankruptcy Court's Confirmation Order, and (2) an injunction prohibiting appellees from consummating the plan of reorganization confirmed thereby, pending this appeal.

Further, the Noteholder Appellants hereby supplement the Stay Motion to highlight certain substantive issues of bankruptcy law raised by this appeal that are of paramount importance to the administration of justice in business bankruptcy cases.

PRELIMINARY STATEMENT

The issues in this case are of national significance to the commercial lending community and the bankruptcy bar. Indeed, even the Bankruptcy Court recognized, in certifying the appeal directly to this Court, that its Confirmation Order "adjudicates issues of ***mammoth*** public importance." "Findings of Fact and

[2] All capitalized terms not otherwise defined herein shall have the same meanings as defined in the Stay Motion.

Conclusions of Law on the Emergency Motion of the Indenture Trustee for Stay Pending Appeal and the Petition for Direct Appeal to the Fifth Circuit Court of Appeals" ("Stay/Petition Findings") at ¶ 51 (emphasis added). A number of the more prominent legal issues incorrectly determined by the Bankruptcy Court are discussed below, but as a threshold matter the Noteholder Appellants point out two matters:

One, both before the Bankruptcy Court and before the District Court, the American Securitization Forum has sought leave to file an amicus curiae brief to express its strong **disapproval** of the confirmation of the Marathon/MRC Plan because of its severely negative impact upon the commercial lending markets.

Two, the Bankruptcy Court in this case, in an exchange with counsel, described its approach to this case, as follows:

> THE COURT: When 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 its finest. ***Go be as ruthless as you want to.***

July 2, 2008 Transcript at 236:14-20 (emphasis added).

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The Noteholder Appellants respectfully submit that this candid statement by the Bankruptcy Court, and the erroneous rulings that followed from the philosophy it revealed, have resulted in a gross distortion of well-established principles of bankruptcy law and, consequently, substantial uncertainty in the commercial lending markets. ***Unless a stay is issued now to prevent this appeal from being rendered moot, there will be no effective appellate review of the Bankruptcy Court's erroneous rulings.***

As described below, the Noteholder Appellants submit that a stay pending appeal as requested in the Stay Motion is both necessary and appropriate and should be issued.

I. THE MRC/MARATHON PLAN EFFECTS AN ILLEGAL DE FACTO SUBSTANTIVE CONSOLIDATION.

It is a fundamental tenet of bankruptcy law that, unless the facts and circumstances satisfy the extraordinarily rigorous prerequisites for substantive consolidation, the assets and liabilities of each debtor entity in bankruptcy must be kept separate from all other debtor and non-debtor entities. Each creditor is entitled, as a matter of both bankruptcy law and applicable non-bankruptcy law, to the satisfaction of its claim out of the assets of its own debtor, without dilution by, or diversion to, creditors of entities other than its debtor. *See, e.g.*, *In re Owens Corning*, 419 F.3d 195. 208-09 (3d Cir. 2005) (substantive consolidation is an extreme remedy requiring an express finding either that (i) the debtors' "assets and

liabilities are so scrambled that separating them is prohibitive and hurts all creditors"; or that (ii) the debtors "disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity"); *In re Augie/Restivo Baking Co.,* 860 F.2d 515, 518 (2d Cir. 1988).

Yet, without ***any*** evidence or finding that the factual predicate for substantive consolidation was satisfied in this case, the Bankruptcy Court confirmed the Marathon/MRC Plan under which the separateness of Scopac's estate from the bankruptcy estate of its parent company, The Pacific Lumber Company ("Palco"), has been violated.

It cannot be legitimately disputed that, under the MRC/Marathon Plan and the Confirmation Order on appeal, value from Scopac's assets (all of which secure the Timber Notes) would be diverted to Palco's creditors despite the fact that the holders of the Timber Notes would receive substantially less than payment in full. Under the MRC/Marathon Plan, value being paid by Newco for assets of Scopac would be used to satisfy creditors of Palco, and the Plan never sets forth in a comprehensible way which estate's assets are being used to pay which estate's creditors.

This *de facto* substantive consolidation is especially pernicious in this case because Scopac was established for the express purpose of segregating the Timberlands from other assets in a special purpose entity that would issue (and did

issue) the Timber Notes. ***The existence of Scopac as a corporate entity separate from Palco was held out as an inducement to the lenders who made the loans evidenced by the Timber Notes issued 10 years ago, and the noteholders relied upon that separateness in acquiring the Timber Notes.***

The Bankruptcy Court gave short shrift to the noteholders' arguments against the *de facto* substantive consolidation embedded in the MRC/Marathon Plan. The Bankruptcy Court's two paragraph discussion of this issue at page 88 of the Findings (under the heading "K. No Substantive Consolidation") failed to address the problem that, since all the value at Palco was being given to Marathon (an indisputably undersecured creditor of Palco), the value which Newco was paying to Palco's unsecured creditors had to be attributable to Scopac's assets, including the Timberlands. The Court made **no** factual finding on this issue. Instead, the Bankruptcy Court merely found that, by requiring two separate litigation trusts (one for Scopac and one for Palco), rather than a single one, it purportedly "solved" any substantive consolidation problem contained in the Plan. However, the Bankruptcy Court never addressed or attempted to explain the source of the consideration to Palco's unsecured creditors.

Because the MRC/Marathon Plan effects an impermissible substantive consolidation, it was clear legal error for the Bankruptcy Court to confirm that plan.

II. THE MRC/MARATHON PLAN VIOLATES THE ABSOLUTE PRIORITY RULE.

Another fundamental tenet of bankruptcy law is that no junior class of claims can receive value under a plan unless all senior classes either have consented (by voting to accept the plan by the requisite majorities) or have been paid in full. *See, e.g.*, *Consol. Rock Prod. Co. v. Du Bois*, 312 U.S. 510, 527-29 (1941) (under the absolute priority rule, secured creditors "must receive . . . compensation for the senior rights which they are to surrender."); *Mokava Corp. v. Dolan*, 147 F.2d 340, 345 (2d Cir. 1945).

The absolute priority rule was violated here because, despite the noteholders' lien on virtually all of Scopac's assets, unsecured creditors who rank junior in priority with respect to those assets would receive a distribution under the MRC/Marathon Plan, even though the secured claims are not being paid in full.

Moreover, there was a further violation of the absolute priority rule as to Scopac's secured and unsecured creditors, because unsecured creditors of Scopac's equity holder – Palco – are being paid out of the proceeds of Scopac's assets. All of the value attributable to the Palco assets is being given to Marathon, which is an undersecured creditor secured by all of Palco's assets. Accordingly, any value being given by Newco to Palco's unsecured creditors ***must*** represent the proceeds of Scopac's assets.

While the Bankruptcy Court's findings of fact and conclusions of law purport to address the absolute priority rule, they simply do not attempt to address the violations described above. In particular, the findings and conclusions attempt to address the absolute priority argument at page 100, under the heading entitled, "4. 11 U.S.C. § 506(a)/Absolute Priority Rule." The Bankruptcy Court found that the absolute priority rule was not violated because, "***Marathon*** is not receiving or retaining any property under the MRC/Marathon Plan on account of Palco's Equity Interest in Scopac." (emphasis added). However, that misses the point: The problem is not that Marathon's receipt of any consideration violated the absolute priority rule, but rather that (i) the payment to Scopac's unsecured creditors under a plan in which creditors secured by all of its assets were not paid in full would violate the absolute priority rule; and (ii) the payment to unsecured creditors of Palco, Scopac's equity holder, out of the proceeds of the Scopac Timberlands violates the absolute priority rule. Thus, the Bankruptcy Court never addressed the Noteholders' actual arguments regarding the absolute priority rule.

The MRC/Marathon Plan violates the absolute priority, and it was therefore a clear error of law to confirm it.

III. <u>THE MRC/MARATHON PLAN UNFAIRLY DISCRIMINATES AMONG CLASSES OF CREDITORS AND IMPERMISSIBLY GERRYMANDERS THE CLASSES</u>

For a bankruptcy court to confirm a plan despite the negative vote of a class, it must find that "the plan does not discriminate unfairly." 11 U.S.C. § 1129(b)(1). Where two classes of unsecured creditors are treated in widely disparate ways, the class of preferentially treated creditors must be narrowly tailored to fit within a demonstrably legitimate justification for the preferential treatment. *In re Sentry Operating Co. of Tex.*, 264 B.R. 850 (Bankr. S.D. Tex. 2001); *In re Snyder Drug Stores, Inc.*, 307 B.R. 889, 894-95 (Bankr. N.D. Ohio 2004).

The MRC/Marathon Plan unfairly discriminates against the Noteholders' Class 9 deficiency claim. It provides for a significantly greater distribution on account of Class 8 claims than on account of Class 9 claims, despite the fact that Class 8 and Class 9 claims ***have equivalent legal priority***.

In an attempt to address the Noteholders' objections to the unfair discrimination inherent in the MRC/Marathon Plan, the Bankruptcy Court made findings that the holders of Scopac Trade Claims, "are small, local creditors in a close-knit and insulated timber community" and that the good will of such trade creditors "is important for the successful future operation of Scopac's business because there is a limited market in which to obtain these goods and services." **[cite to findings]**

These findings are inconsistent with the ***undisputed*** record for three reasons. First, Class 8 specifically includes "claims of former employees" who have not worked for Scopac for over 16 months, and as to whom the Bankruptcy Court itself previously denied a motion to pay benefits on the basis that there was no benefit to the Debtor from paying the pre-petition claims of these former employees. Thus, there is no evidence that "Scopac's operations will suffer" if these Class 8 creditors – former employees – are not paid.

Second, these Findings ignored the ***undisputed*** evidence that trade creditors in Class 8 depend on Scopac for their livelihood; that Scopac is the second largest timber operator in Humboldt County; and that Scopac is a "very valuable" customer for local creditors.

Third, the testimony was ***undisputed*** that Class 8 includes some *national* creditors and not merely local creditors.

Because Class 8 includes national creditors (and not just local creditors), former employees (who are not necessary for future operations), and at least some local creditors who depend on Scopac for their livelihood, the discriminatory treatment of Class 8 was overinclusive; that is, Class 8 was not narrowly defined to include only those creditors who were not likely to do business with Scopac or its successor if not paid in full. It is apparent that the MRC/Marathon Plan fails to

meet the essential requirement for confirmation under Bankruptcy Code section 1129(b)(1) that the plan "not discriminate unfairly."

Moreover, the Bankruptcy Court effectively ignored well-established Fifth Circuit precedent holding that Plan proponents must not separately classify claims in order to gerrymander an impaired accepting class (*see Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1279 (5th Cir. 1991) ("thou shall not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.")). In addition, the Bankruptcy Court ignored binding Fifth Circuit precedent holding that plan proponents must not artificially impair a class of claims in order to create an impaired accepting class. *See In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346, 1353 (5th Cir. 1989) (remanding to determine whether plan that "technically impaired" a class was proposed in good faith).

Because the MRC/Marathon Plan unfairly discriminates among the classes of creditors and impermissibly gerrymanders the classes, it was legal error for the Bankruptcy Court to confirm it.

IV. THE MRC/MARATHON PLAN DEPRIVES THE NOTEHOLDERS OF THEIR STATUTORY RIGHT TO CREDIT BID AND FAILS TO PROVIDE THE NOTEHOLDERS WITH THE "INDUBITABLE EQUIVALENT" OF THEIR SECURED CLAIMS.

The Bankruptcy Court – in what, at best, can be generously described as a surprise to the commercial lending industry and bankruptcy practitioners –

apparently believes that, upon the lifting of a debtor's exclusive right to file a plan of reorganization, it is quite reasonable to "steal" a company by proposing a plan of reorganization. *See* July 2, 2008 Transcript at 236:14–20. Indeed, the Bankruptcy Court openly criticized the Noteholders for failing themselves to propose a plan that would "steal" the Palco assets by cramming down Marathon. *See* July 2, 2008 Transcript at 236:20 – 238:13; July 7, 2008 Transcript at 14:18-19 ("Thus, the IT had perhaps a 20-to-1 leverage advantage over Marathon to propose a buyout of all the assets.")

With all due respect, the Noteholders disagree that the Bankruptcy Code ***ever*** permits a plan proponent to "steal" assets under a plan of reorganization. In addition to the critically important "good faith" requirement set forth in Bankruptcy Code § 1129(a)(3), the Bankruptcy Code protects against such theft by ***mandating that a secured creditor have the right to credit bid in connection with any forced sale of its collateral.***

The plain meaning of Bankruptcy Code § 1129(b)(2)(A)(ii) provides for the right of the secured creditor to credit bid:

> (2) For the purpose of this subsection [dealing with "cram down" of a plan over the objection of a non-accepting class], the condition that a plan be fair and

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> equitable with respect to a class includes the following requirements:
>
> > (A) With respect to a class of secured claims, the plan provides—
> >
> > > (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; . . . .

11 U.S.C. § 1129(b)(2)(A)(ii) (emphasis added).

Bankruptcy Code § 363(k) affords the secured creditor the important right to credit bid its claim. It is that provision that protects a secured creditor against a plan designed to "steal" its collateral. The Bankruptcy Court in this case eviscerated that protection.

Although the Bankruptcy Court "found" that the MRC/Marathon Plan involves a "transfer" rather than a "sale" to Newco, there is no dispute that this plan proposes a transfer of ownership of the Timberlands from Scopac to Newco in exchange for cash; ***as a matter of law*** – as a matter of statutory construction – a

"transfer" for cash is a "sale" within the meaning of Bankruptcy Code section 1129(b)(2)(A)(ii).[3] The facts are clear and undisputed, but the Bankruptcy Court's legal conclusion that the proposed transaction does not constitute a "sale" within the meaning of the statute is an error of law mandating reversal.

Moreover, the Bankruptcy Court relied on the broad, general language of 1129(b)(2)(A)(iii), which speaks in terms of "indubitable equivalent," and ignored the specific requirements of 1129(b)(2)(A)(ii), which mandates a right to credit bid in connection with a sale of the collateral. In doing so, the Bankruptcy Court disregarded two long-established principles of statutory construction which complement one another here.

First, "[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)); *see also In re Balderas*, 328 B.R. 707, 720 n.18 (Bankr. W.D. Tex. 2005) ("The general rule of statutory construction applicable to the court's conclusion is that which states that, when statutory provisions appear to conflict, the more specific provision should control over the more general."). Section 1129(b)(2)(A)(ii) deals specifically with a sale free and clear of liens and specifically prescribes the minimum steps required to satisfy the "fair and equitable" requirement when a

[3] *Cf.* Uniform Commercial Code § 2106(1): "A 'sale' consists in the passing of title from the seller to the buyer for a price . . . ."

secured creditor's collateral is sold free and clear of its lien, which include providing the secured creditor with an opportunity to protect itself by credit bidding. In contrast, section 1129(b)(2)(A)(iii) sets forth the much more general alternative of providing the secured creditor with the "indubitable equivalent" of its interest in the collateral, and does not specifically reference a sale free and clear of liens. Therefore, section 1129(b)(2)(A)(ii) controls over section 1129(b)(2)(A)(iii) with respect to free and clear sales under a plan, and an opportunity for the secured creditor to credit bid is required.

Second, "[i]t is 'a cardinal principle of statutory construction' 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.'" *In re Toro-Arcila*, 334 B.R. 224, 227 (Bankr. S.D. Tex. 2005) (quoting *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 of collateral free and clear of liens -- the ***only*** situation covered by section 1129(b)(2)(A)(ii) -- may satisfy the "fair and equitable" requirement without including a corresponding opportunity for a secured creditor to credit bid, then section 1129(b)(2)(A)(ii) would be eviscerated and rendered superfluous. *See generally, 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)(A)(2)(i) and (ii) would not satisfy [section 1129(b)(2)(A)(iii)]."). In order to avoid reading section 1129(b)(2)(A)(ii) out of the statute, free and clear sales under a plan must be held to be subject to the terms of this section (including credit bid rights), and not authorized under the more general "indubitable equivalent" provisions of section 1129(b)(2)(A)(iii).

The credit bid requirement of Bankruptcy Code sections 1129(b)(2)(A)(ii) and 363(k) is necessary to protect secured creditors against the imperfections and possibility of abuse inherent in relying on appraisers engaged by interested parties.

Even if it were somehow appropriate to apply section 1129(b)(2)(A)(iii) rather than section 1129(b)(2)(A)(ii), the Bankruptcy Court's use of that provision in this case was erroneous as a matter of law. Because "indubitable equivalent" is left undefined in the Bankruptcy Code, courts analyzing plans proposing "indubitable equivalent" treatment of rejecting classes of secured claims have insisted upon evidence that the secured creditor will receive treatment under the plan that is "completely compensatory." *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935). In *B.M. Brite v. Sun Country Dev., Inc. (In re Sun Country Dev., Inc.)*, 764 F.2d 406 (5th Cir. 1985), the Fifth Circuit's opinion explained that there must be "no reasonable doubt that the creditor will receive the full value of what it bargained for when it made its contract with the debtor . . . ." Id. at 409. Transferring the collateral securing a creditor's claim for less than the full amount

of such claim, while destroying that creditor's right to credit bid, cannot possibly be "completely compensatory" and falls far short of "no reasonable doubt."

By depriving the Noteholders of their statutory right under Bankruptcy Code sections 1129(b)(2)(A)(ii) and 363(k) to credit bid, the Bankruptcy Court exposed the Noteholders to mischief. The Court relied upon a questionable appraisal presented by an interested party to value the collateral at an artificially low amount, and then permitted a sale of the property (labeled by Marathon/MRC as a "transfer") at that low amount while precluding the holders of Timber Notes from protecting themselves by credit bidding or permitting any competitive bidding. It is inconceivable that the Supreme Court would regard the travesty that has occurred in this case as satisfying the admonitions it provided in *La Salle*. *See Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. Pshp.*, 526 U.S. 434, 119 S. Ct. 1411, 1423 (1999) ("[I]t was, after all, one of the Code's innovations to narrow the occasions for courts to make valuation judgments . . ."). The Noteholder Appellants respectfully submit that it was a gross error of law for the Court below to so rule and that a stay must be issued so that the error can be rectified on appeal in this case and so that the commercial lending community can be provided necessary guidance.[4]

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[4] In denying a stay pending appeal, the Bankruptcy Court stated that the primary issue on appeal is the determination of the value of the Timberlands, which the Bankruptcy Court characterized as a factual issue subject to the clearly erroneous

V. **The Security Arrangements That Have Been Proposed By The Indenture Trustee Significantly Exceed The Legal And Practical Requirements To Maintain The Status Quo Pending Appeal.**

The Indenture Trustee, as authorized by the requisite number of Timber Notes, previously proposed up to $50 million in security arrangements for the duration of the stay, including a $25 million debtor in possession loan to Scopac's estate, which would "prime" the Noteholders' secured claims and the provision by Scopac to Palco, without charge, of up to $25 million in logs constituting the Noteholders' collateral. These arrangements would enable Scopac and Palco to continue to operate as going concerns through at least the end of this year. Consequently, if the confirmation order were to be affirmed and the Plan were to become effective, Newco would acquire both an operating Scopac and an operating Palco.

To address the extremely remote circumstance that MRC and Marathon might walk away from the deal, the Indenture Trustee proposed in the Bankruptcy Court a reasonable and feasible solution, which the Bankruptcy Court *completely ignored.* In summary, that proposal provided that the stay would remain in place for at least 60 days, and shortly prior to the expiration of the 60-day deadline by

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standard. The premise of the Bankruptcy Court's statement – that the primary issue on appeal, is valuation – is flatly wrong. The primary issues on appeal are the issues of law discussed above, together with several additional legal and factual bases for reversal. Appellants must be granted a stay pending appeal so that these issues can be briefed and determined.

which Marathon and MRC had the right to walk away from their plan, if they intended to not extend, then they would provide notice of such intention. At that point, there would be a hearing to determine whether any additional security was needed to keep the stay in place; if such additional was required and was posted, Marathon and MRC's plan would be null and void in accordance with its terms.

PRAYER

Noteholder Appellees ask this Court to expedite consideration of this motion, to act on or before July 24, 2008, and to issue a status quo order staying the Bankruptcy Court's Confirmation Order and enjoining appellees from effectuating the plan of reorganization confirmed thereby pending this appeal. Noteholder Appellees also request expedited briefing and oral arguments and all other appropriate relief to which they may be entitled.

Dated: July 22, 2008
Los Angeles, CA

Respectfully submitted,

STUTMAN, TREISTER & GLATT P.C.

By: *<u>/s/ Eric D. Winston</u>*

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