

**DRAFT-1/30/08-SUBJECT TO MATERIAL REVISION**

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

IN RE:  SCOTIA DEVELOPMENT LLC, THE PACIFIC LUMBER COMPANY, BRITT LUMBER CO., INC., SALMON CREEK LLC, SCOTIA INN INC., and SCOTIA PACIFIC COMPANY LLC,  DEBTORS.	Chapter 11 Case Nos. 07-20027 through 07-20032 (Jointly Administered)
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**DISCLOSURE STATEMENT IN SUPPORT OF  
JOINT PLAN OF REORGANIZATION  
FOR THE DEBTORS PROPOSED BY  
MENDOCINO REDWOOD COMPANY, LLC AND  
MARATHON STRUCTURED FINANCE FUND L.P.**

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**DISCLAIMER**

**THIS IS NOT A SOLICITATION OF ACCEPTANCE OR REJECTION OF THE PLAN. ACCEPTANCES OR REJECTIONS MAY NOT BE SOLICITED UNTIL THE BANKRUPTCY COURT HAS APPROVED THIS DISCLOSURE STATEMENT. THIS DISCLOSURE STATEMENT IS BEING SUBMITTED FOR APPROVAL BUT HAS NOT YET BEEN APPROVED BY THE COURT**

Dated: \_\_\_\_\_, 2008

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### **INTRODUCTION**

*NOTE: This is a proposed form of Disclosure Statement for which the Plan Proponents are seeking the Bankruptcy Court's approval. Upon approval, the Plan Proponents will distribute this Disclosure Statement to all Holders of Claims and Interests who are entitled to vote on the Plan, as well as to all parties who have requested copies of the final Disclosure Statement. No votes are being solicited at this time, and no deadlines have been set for objecting to the confirmation of the Plan. Upon approval of this Disclosure Statement, as amended (if appropriate), the Bankruptcy Court will establish deadlines and procedures for the distribution of this document in its final form, in connection with the solicitation of votes.*

*Please consult the Uniform Glossary of Defined Terms for Plan Documents attached as Appendix A to the Plan for the meaning of initially capitalized terms.*

**INFORMATION CONTAINED IN THIS DISCLOSURE STATEMENT IS INCLUDED HEREIN FOR PURPOSES OF SOLICITING ACCEPTANCES OF THE JOINT PLAN OF REORGANIZATION OF THE DEBTORS, AND MAY NOT BE RELIED UPON FOR ANY PURPOSE OTHER THAN TO DETERMINE HOW TO VOTE ON THE PLAN. NO PERSON MAY GIVE ANY INFORMATION OR MAKE ANY REPRESENTATIONS, OTHER THAN THE INFORMATION AND REPRESENTATIONS CONTAINED IN THIS DISCLOSURE STATEMENT, REGARDING THE PLAN OR THE SOLICITATION OF ACCEPTANCES OF THE PLAN.**

**ALL CLAIM AND INTEREST HOLDERS ARE ADVISED AND ENCOURAGED TO READ THIS DISCLOSURE STATEMENT AND THE PLAN IN THEIR ENTIRETY BEFORE VOTING TO ACCEPT OR REJECT THE PLAN. PLAN SUMMARIES AND STATEMENTS MADE IN THIS DISCLOSURE STATEMENT ARE QUALIFIED IN THEIR ENTIRETY BY REFERENCE TO THE PLAN AND THE EXHIBITS ANNEXED TO THE PLAN AND THIS DISCLOSURE STATEMENT. THE STATEMENTS CONTAINED IN THIS DISCLOSURE STATEMENT ARE MADE ONLY AS OF THE DATE HEREOF, AND THERE CAN BE NO ASSURANCE THAT THE STATEMENTS CONTAINED HEREIN WILL BE CORRECT AT ANY TIME AFTER THE DATE HEREOF.**

**IN THE EVENT OF ANY CONFLICT BETWEEN THE STATEMENTS SET FORTH IN THIS DISCLOSURE STATEMENT AND THE TERMS OF THE PLAN, THE TERMS OF THE PLAN SHALL GOVERN.**

**THIS DISCLOSURE STATEMENT HAS BEEN PREPARED IN ACCORDANCE WITH SECTION 1125 OF THE UNITED STATES BANKRUPTCY CODE AND RULE 3016(b) OF THE FEDERAL RULES OF BANKRUPTCY PROCEDURE AND NOT NECESSARILY IN ACCORDANCE WITH FEDERAL OR STATE SECURITIES LAWS OR OTHER NONBANKRUPTCY LAW.**

**THIS DISCLOSURE STATEMENT HAS BEEN NEITHER APPROVED NOR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION ("SEC"), NOR HAS THE SEC PASSED UPON THE ACCURACY OR ADEQUACY OF THE STATEMENTS CONTAINED HEREIN. PERSONS OR ENTITIES TRADING IN OR OTHERWISE PURCHASING, SELLING, OR TRANSFERRING SECURITIES OR CLAIMS OF THE DEBTORS OR ANY OF ITS SUBSIDIARIES AND AFFILIATES SHOULD EVALUATE THIS DISCLOSURE STATEMENT AND THE PLAN IN LIGHT OF THE PURPOSE FOR WHICH THEY WERE PREPARED.**

**AS TO CONTESTED MATTERS, ADVERSARY PROCEEDINGS, AND OTHER ACTIONS OR THREATENED ACTIONS, THIS DISCLOSURE STATEMENT SHALL NOT CONSTITUTE**

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**OR BE CONSTRUED AS AN ADMISSION OF ANY FACT OR LIABILITY, STIPULATION OR WAIVER, BUT RATHER AS A STATEMENT MADE IN SETTLEMENT NEGOTIATIONS. THIS DISCLOSURE STATEMENT SHALL NOT BE ADMISSIBLE IN ANY NON-BANKRUPTCY PROCEEDING NOR SHALL IT BE CONSTRUED TO BE CONCLUSIVE ADVICE ON THE TAX, SECURITIES, OR OTHER LEGAL EFFECTS OF THE PLAN AS TO HOLDERS OF CLAIMS AGAINST, OR EQUITY INTERESTS IN THE DEBTORS.**

Mendocino Redwood Company, LLC and Marathon Structured Finance Fund L.P. (collectively, the "Plan Proponents") are soliciting acceptances of the Plan (a copy of which is attached hereto as Exhibit A) for Scotia Development LLC ("Scotia Development"), The Pacific Lumber Company ("Palco"), Britt Lumber Co., Inc. ("Britt") Salmon Creek LLC ("Salmon Creek"), Scotia Inn Inc. ("Scotia Inn") and Scotia Pacific Company LLC ("Scopac"), as debtors (collectively the "Debtors"). This solicitation is being conducted in order to obtain sufficient acceptances to enable the Plan to be confirmed by the Bankruptcy Court pursuant to the provisions of section 1129 of the Bankruptcy Code.

### **EXECUTIVE SUMMARY**

The Plan Proponents propose to reorganize the Debtors by integrating the commercial timberland and sawmill operations and managing them in a responsible and sustainable manner pursuant to a business plan developed by MRC. MRC is an experienced and environmentally responsible operator of an integrated commercial redwood timberland, sawmill and lumber distribution operation located in nearby Mendocino County. The Plan Proponents also propose to restructure the Town of Scotia and allow residents to purchase their homes. In addition, the Plan will substantially reduce the amount of debt that presently burdens the Debtors to a level that is serviceable from operating profits, provides substantial recoveries to all creditors and preserves jobs, pensions, business operations, and going-concern value.

The principal elements of the Plan are as follows:

1. The Plan Proponents will contribute \$225 million of Cash and convert approximately \$135 million of senior secured pre-petition and post-petition debt into equity.
2. The Plan Proponents will bring in a new experienced management team from MRC with a proven track record of success in the redwood forest and lumber business. The commercial timberland and sawmill operations will be integrated and managed by MRC in a responsible and sustainable manner. MRC's management team is well-versed in enlightened forestry practices and has been praised by environmental organizations,
3. Newco will benefit from approximately \$10 million annually of synergies that will be realized as a result of MRC sharing its management, relationships and infrastructure with Newco.
4. The debt obligations of the Debtors will be reduced by a total of approximately \$[625] million, and, as a result, the Reorganized Entities will be able to responsibly service their debt obligations going forward.

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5. Trade creditors will be paid cash in the amount of approximately 75% of their claims and will be eligible for further distributions.
6. The Holders of Timber Notes will receive \$175 million plus new Timber Notes issued in the principal amount of \$325 million secured by the Debtors' Timberlands and be eligible for further distributions.
7. The Debtors' Pension Plan will be assumed.
8. The Town will be reorganized and residents will be allowed to purchase their homes.
9. Bank of America's \$[\_\_\_] million loan to Scopac will be paid in full.
10. All allowed administrative and administrative priority claims of all Debtors will be paid in full.
11. The Debtors' litigation assets will be pursued by a Litigation Trustee for the benefit of all unsecured creditors.

Most importantly, the Plan can be fully implemented following Confirmation. The \$225 million of new capital provided by the Plan Proponents and MRC's experienced management team and business plan are committed and ready to be put into operation.

### **The Plan Proponents**

MRC, owned by the Fisher family from San Francisco California, is considered to be a successful manager of its integrated commercial redwood timberlands, having developed good and positive working relationships with the regulatory, environmental and residential communities. In addition, MRC has demonstrated measurable ecological progress in the management of its forestry operations. MRC's affiliate, Mendocino Forest Products Company, LLC ("MFP") operates a successful redwood lumber sawmill and related distribution business in Ukiah, California. Moreover, MFP has been a significant customer of Palco for close to ten years, and thus is familiar with many the operational problems that have plagued the company.

Marathon is the Administrative Agent and a lender to the Palco Debtors. Marathon has provided a total of \$160 million in pre-petition and post-petition "DIP" financing to the Palco Debtors. Marathon has determined to convert much of its debt into equity in the Reorganized Entities, and, along with MRC, provide \$225 million of new equity capital to enable the reorganization of the Debtors. In addition, Marathon will use its expertise in real estate and real estate financing to restructure the Town with the eventual goal of allowing the Town's residents to purchase their homes.

### **The Debtors' Assets and Operations**

The Debtors' primary assets consist of (i) commercial timberland operations (the "Timberlands") (ii) sawmill operations (the "Mill") and (iii) the Town of Scotia, California (the "Town").

The Timberlands consist of two components. The first is approximately 210,000 acres of commercially operated timberlands that historically have generated the bulk of the Debtors' cash



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flows. The second component consists of six groves of ancient redwood trees totaling approximately 6,600 acres. These groves contain primarily old-growth redwood timber and a habitat used by marbled murrelet, a coastal seabird, and have been designated as "marbled murrelet conservation areas or "MMCA's." The MMCA's are not part of the Debtors' forestry operations and are subject to various environmental restrictions that prevent commercial harvesting.

The Mill consists of a sawmill located in Scotia and lumber marketing and distribution operations. The Debtors once operated five sawmills, but have since consolidated them into the one sawmill that was constructed in 2006.

The Town consists of primarily 270 homes, a co-generation plant and various commercial properties. Many of the Debtors' employees live in the Town and pay rent to the Debtors. The Town includes a sawmill in Arcata, California that is being shut down and its equipment is being liquidated.

### **The Debtors' Bankruptcies**

The Debtors' commercial timberland and mill operations have declined for some time. The causes for the Debtors' decline and eventual filing of these chapter 11 cases are numerous. Since 1986, the Debtors have borrowed heavily and, despite significant reductions in their standing inventory of conifer timber and a sale of lands for more than \$300 million in conjunction with the Headwaters Agreement in 1999, the Debtors have over \$200 million more debt today than when they were formed more than twenty years ago. The Debtors are currently unable to service their payment obligations to secured creditors.

Other factors that have contributed to the Debtors' deterioration include inefficient operations, poor customer service, competition from other products, a decline in housing construction and hostility and litigation with regulators, the local community and non-governmental environmental organizations.

The Debtors contend that their bankruptcies are the result of the debt they incurred and their inability to harvest at a level necessary to service their debt due to a "snarl of litigation" with regulators and the environmental community. However, the Plan Proponents believe the Debtors' problems are larger, and include a need for a new capital structure, a new long term strategic objective, a different approach with regulators and the community and a change in management to address issues with respect to the Debtors' operations. Accordingly, the Plan Proponents submit that the optimal plan of reorganization for the Debtors must address each of these issues.

### **The Reorganized Entities will Perform all Environmental Obligations**

MRC has a proven track record of operating an environmentally responsible forestry business. In addition, MRC has operated in an open and transparent fashion with regulators, the environmental community and local residents. Moreover, several environmental organizations have indicated that they view MRC's proposed involvement in the Debtors' reorganization efforts in a positive manner.

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MRC has obtained certification from the Forest Stewardship Council on its forestry operations, and MRC intends to immediately seek the same certification for Newco. Forest Stewardship Council certification is an independent third party standard of exemplary forest management supported by leading environmental groups, such as World Wildlife Fund, Natural Resources Defense Council and Greenpeace.<sup>1</sup>

The Plan requires the Reorganized Entities to satisfy, complete, perform, and comply with all Environmental Obligations. Thus, the reorganization will ensure that all environmental regulations are complied with.

The Debtors' track record with environmental regulators has been the subject of much controversy and litigation. In contrast, MRC's management team that will operate Newco has positive relationships with various environmental regulators.

### **The Debtors' Plan to Build "Kingdom Homes"**

The Debtor's plan of reorganization is to develop "kingdom homes" in the areas surrounding the environmentally sensitive MMCAs. The Debtors assert that, through the sale of the MMCAs and their luxury home development, they will yield almost \$1.2 billion in gross proceeds that will be used to repay creditors in full. The Debtors estimate that it will take some five to eight years to complete the sale of the MMCAs and their luxury home development to generate these revenues. The luxury home development will also require a sizable investment for not only luxury homes, but a hunting lodge, golf course and other features the Debtors believe are necessary for the sale of the luxury homes.

In addition, the Debtors submit that the Debtors' commercial timberlands are worth more than the outstanding secured debt of the Timber Notes, although the Debtors concede that operating revenues from their proposed integrated commercial timberland and sawmill operations will be insufficient to service that debt.

The Plan Proponents believe there will be significant opposition to the Debtors' plan from creditors, regulators, the environmental community and local residents. Indeed, the Debtors' proposed luxury home development in the middle of the redwood forest has already generated significant outcry. Moreover, the Plan Proponents do not believe that the proposed sale of the MMCAs can generate sufficient revenue to pay for the Debtors' proposed luxury home development.

Accordingly, the Plan Proponents urge creditors to vote against the Debtors' proposed plan.

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<sup>1</sup> See [www.fscus.org/membership](http://www.fscus.org/membership) for a complete list of current NGO members of the Forest Stewardship Council in the United States.

**The Timber Notes' Plan to Liquidate**

The Pre-petition Indenture Trustee for the Timber Notes has proposed a plan of liquidation that requires a sale, within six months, of Scopac's property, which the Indenture Trustee admits would yield a price insufficient to pay the Scopac secured debt in full.

The Plan Proponents believe a liquidation of Scopac would be destructive of value not only for creditors of Scopac, but also for the reorganization efforts of the other Debtors. Such a plan may well force the closing of the Mill and derail efforts to reorganize the Town. Indeed, there would be a significant risk of the other Debtors being forced to convert their Reorganization Cases to chapter 7.

Accordingly, the Plan Proponents urge all creditors to reject the Plan of the Pre-petition Indenture Trustee.

**The Reorganization Plan of the Plan Proponents**

The Plan Proponents submit that their Plan is based on what is realistically achievable. It maximizes value from the Debtors' existing assets. Most creditors would not receive a full recovery, but *will* receive a substantial recovery.

The Plan Proponents believe they have compiled all the elements of a successful reorganization for all Debtors: an experienced management team, a realistic business plan that maximizes value for all creditors, and the commitment of significant cash.

More importantly, the Plan of the Plan Proponents is not based on the extremes of the other plan proponents. The Debtors' plan to pay creditors in full is essentially based the transformation of the redwood forest into a vacation paradise for the wealthy. The plan of the Pre-petition Indenture Trustee is to liquidate their collateral with little if any recovery for other creditors and with no reorganization of the other Debtors, leading to substantial risks for the Mill's operations and employees and the Town's residents.

**Summation**

The Plan Proponents urge all creditors to vote to accept the Plan.

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**THE PURPOSE OF DISCLOSURE STATEMENTS IN BANKRUPTCY**

This Disclosure Statement describes the history of the Debtors, their businesses, and the reorganization proposed by the Plan Proponents. This Disclosure Statement provides specific information about the proposed Plan and other alternative plans proposed by the Debtors and the Pre-petition Indenture Trustee for the Timber Notes. In addition, this Disclosure Statement informs the Holders of Claims and Interests of their rights under the Plan. Holders of Claims or Interests that are "impaired" are provided with information to assist them in making an informed judgment regarding whether they should vote to accept or reject the Plan. Finally, this Disclosure Statement provides information to assist the Bankruptcy Court in determining whether the Plan complies with the provisions of chapter 11 of the Bankruptcy Code and should be "confirmed, i.e. approved and made effective.

By order dated [\_\_\_\_\_, 2008], attached hereto as Exhibit B, the Bankruptcy Court approved this Disclosure Statement, in accordance with section 1125 of the Bankruptcy Code, as containing "adequate information to enable a hypothetical, reasonable investor typical of Holders of Claims against the Debtors to make an informed judgment as to whether to vote to accept or reject the Plan. The Bankruptcy Court also authorized the use of this Disclosure Statement in connection with the solicitation of votes with respect to the Plan. **APPROVAL OF THIS DISCLOSURE STATEMENT, HOWEVER, DOES NOT CONSTITUTE A DETERMINATION BY THE BANKRUPTCY COURT AS TO THE FAIRNESS OR MERITS OF THE PLAN.** No solicitation of votes on the Plan may be made except pursuant to this Disclosure Statement and section 1125 of the Bankruptcy Code.

This Disclosure Statement is not intended to replace a careful and detailed review and analysis of the Plan by each Holder of a Claim or Interest but instead is intended only to aid and supplement that review. Any description of the Plan is a summary only. Holders of Claims and Interests and other parties in interest are cautioned to review the Plan and any related attachments in their entirety for a full understanding of the Plan's provisions. This Disclosure Statement is qualified in its entirety by reference to the full text of the Plan, the Plan Supplement and the exhibits and attachments thereto. If any inconsistency exists between the terms of the Plan and this Disclosure Statement, the terms and provisions of the Plan will control.

Certain of the statements contained in this Disclosure Statement are forward-looking projections and forecasts based upon certain estimates and assumptions. Such statements may prove to be wrong or materially different from actual future results, and there can be no assurance that such statements will reflect actual outcomes. The statements contained in this Disclosure Statement, moreover, are made as of the date hereof unless otherwise specified herein, and the delivery of this Disclosure Statement does not imply that there has been no change in the information set forth herein since such date.

Holders of Claims against the Debtors are encouraged to read and carefully consider the matters described in this Disclosure Statement, including Sections [\_\_\_] (Summary of the Proposed Plan) and [\_\_\_] (Risks of the Plan), before voting. Before voting on the Plan, each Holder of a Claim should consult such Holder's attorney, accountant, tax advisor, and/or financial advisor as to the effect of the Plan on such Holder, including without limitation the tax effects of the Plan.

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In making a voting decision, each Holder must rely on the Holder's own examination of the Debtors and the terms of the Plan, including the merits and risks involved.

This Disclosure Statement may not be relied upon for any purpose other than to determine whether to vote in favor of or against the Plan, and nothing contained herein will constitute an admission of any fact or liability by any party, or be admissible in any proceeding involving the Debtors, the Reorganized Entities or any other party, or be deemed evidence of the tax or other legal consequences or effects of the reorganization of the Debtors.

The statements and information about the Debtors and Reorganized Entities, including financial information, financial projections, and information regarding Claims or Interests contained in this Disclosure Statement, have been prepared from information provided by the Plan Proponents and their advisors. No statement or information concerning the Debtors and Reorganized Entities (particularly as to future business, results of operations or financial condition, or with respect to distributions to be made under the Plan) or their assets, properties, or businesses that is given for the purpose of soliciting acceptances of the Plan is authorized, other than as set forth in this Disclosure Statement.

### **SUMMARY OF VOTING PROCEDURES**

The Plan Proponents have sent Ballots with voting instructions and copies of this Disclosure Statement to all known Holders of Claims in Impaired Classes that are entitled to vote on the Plan. All Holders of Impaired Claims should read their Ballots carefully and follow the voting instructions accurately. Holders of Claims should use only an official Ballot.

#### **A. WHO CAN VOTE?**

The Bankruptcy Code provides that the only Classes of Claims that are entitled to vote on the Plan are those that are both (i) "Impaired" by the Plan and (ii) entitled to receive a distribution under the Plan. Classes of Claims or Interests that are "unimpaired" are deemed to vote "yes," while Classes that will receive nothing at all are deemed to vote "no." Under the Plan, only Claims in Classes 3, 4, 6, 7, 8, 10 and 11 are Impaired and, accordingly, the Holders of Claims in those Classes are the only Holders of Claims entitled to vote to accept or reject the Plan. Because Claims and Interests in Classes 1, 2, and 5 are unimpaired by the Plan, the Holders of Claims and Interests in such Classes are conclusively presumed by operation of the Bankruptcy Code to have accepted the Plan. Holders of Claims and Interests in Classes 12, 13 and 14 will receive no distribution and are deemed to reject the Plan.

For purposes of voting, the Bankruptcy Court has established \_\_\_\_\_, 2008 as the Record Date for determining whether a creditor whose Claim is based on the Debtors' books and records is entitled to vote to accept or reject the Plan.

#### **B. WHAT IS THE DEADLINE FOR VOTING?**

In order for your vote to be counted for voting purposes, Ballots accepting or rejecting the Plan must be *physically* received by the Balloting and Claims Agent no later than 4:00

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p.m., prevailing Central Time, on \_\_\_\_\_2008. Please allow adequate time for delivery.

Although electronic filing is available for other types of pleadings in these Reorganization Cases, it is not available for the submission of Ballots. To ensure the integrity of the voting process, all Ballots must be submitted as originals and must bear an original signature in order to be counted. Late Ballots will be given no effect. Please plan on voting so that the Ballots can be received in time to be counted.

**C. WHERE AND HOW DO I RETURN MY BALLOT?**

Ballots should be returned to \_\_\_\_\_, the Balloting and Claims Agent for the Plan Proponents, at:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Attn: Scotia Development Voting Department

In order to have your vote count, you must sign and return the Ballot accompanying this Disclosure Statement to the Balloting and Claims Agent by the deadline set forth above. You may return your Ballot by mail, and delivery, or overnight courier. However, the Balloting and Claims Agent is not able to accept Ballots by email or facsimile. A pre-addressed, postage-prepaid envelope is included for your convenience.

**D. CAN MY ATTORNEY VOTE FOR ME?**

Yes, under certain circumstances. If you (i) have authorized your attorney to vote for you and (ii) have not changed those arrangements, your attorney may vote as your agent. If your attorney votes on your behalf, you do not need to complete a Ballot. If you have not authorized your attorney to vote for you, only you may vote on the Plan.

**E. I AM AN ATTORNEY VOTING ON BEHALF OF MY CLIENT-WHAT DO I NEED TO DO?**

Attorneys voting on behalf of clients must use and complete the Ballot sent to the client. Attorneys may vote only for those clients from whom the attorney has obtained authorization to do so. Ballots cast by attorneys on behalf of their clients must be received by the Debtors' Balloting and Claims Agent at the address listed on the Ballot by no later than 4:00 pm., prevailing Central Time, on \_\_\_\_\_2008. Ballots may be returned by mail, hand delivery, or overnight courier. However, the Balloting and Claims Agent is unable to accept Ballots by email or facsimile. Please allow enough time for delivery.

**F. WHAT DO I DO IF I RECEIVED MORE THAN ONE BALLOT?**

It is possible for a single person or entity to hold Claims or Interests in more than one class or against more than one of the Debtors. If so, you may be entitled to vote in more than

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one Class, and you should have received more than one Ballot. Please review each of the Ballots carefully and consult with your legal and financial advisors for further advice if necessary. A vote on one Ballot will be effective only in the Class specified in that Ballot. In order to have your vote count in more than one Class, if applicable, you must submit more than one Ballot.

**G. WHAT DO I DO IF I DID NOT RECEIVE A BALLOT WITH MY SOLICITATION PACKAGE OR DID NOT RECEIVE A BALLOT FOR EACH CLASS IN WHICH I AM ENTITLED TO VOTE, OR NEED A REPLACEMENT BALLOT?**

If you are a Holder of a Claim entitled to vote on the Plan and (1) did not receive a Ballot, (2) received a damaged Ballot, or (3) lost your Ballot (and you are not voting through your attorney), you should contact the Balloting and Claims Agent, at 1-800-\_\_\_\_\_ or by email at \_\_\_\_\_@\_\_\_\_\_.com.

Extra copies of Ballots also may be downloaded at no charge to you from the website:www.\_\_\_\_\_.com. You must take care to download the correct Ballot for the Class(es) in which you are entitled to vote.

If you have any questions about the procedures for voting on the Plan, you should contact your attorney or the Balloting and Claims Agent.

**For detailed voting instructions, see the instructions accompanying your Ballot. Please read and follow the instructions closely to ensure that your vote is counted.**

**SUMMARY OF MATERIAL TERMS OF THE PROPOSED PLAN**

The following is a brief summary of certain material provisions of the Plan. By necessity, this summary is incomplete and is qualified in its entirety by reference to the more detailed information appearing elsewhere in this Disclosure Statement, the attached exhibits, the Plan, and the exhibits thereto, as amended from time to time. Please read the entire Disclosure Statement carefully before deciding how to vote because your rights may be affected by implementation of the Plan.

If approved, the Plan will implement a reorganization that will address the Debtors' liabilities in a comprehensive and complete manner. The Plan Proponents have sought to formulate a plan of reorganization that is fair and equitable to all parties in interest, while allowing the restructuring of the Debtors' balance sheets. The Plan Proponents believe that these objectives have been met, and that the Plan provides for the maximum recoveries to, and expeditious and equitable treatment of, all Holders of Claims and Interests.

**Summary Description of Classes and Distributions  
to Holders of Claims and Interests**

However, the Plan consolidates certain Classes with one another for voting and distribution purposes.

If the Bankruptcy Court authorizes the Debtors to consolidate certain Classes for voting and distribution purposes, each of those Classes of Claims and Interests against certain Debtors will be treated as a Claim or Interest in or against a single consolidated Estate, without regard to the separate identification of the Debtors. If the Bankruptcy Court authorizes the Debtors to consolidate for voting and distribution purposes fewer than all of the Classes of Claims sought to be consolidated for these purposes, the Plan Proponents may, among other options discussed in Section [\_\_\_], proceed with separate classifications for any such non-consolidated Classes. If the Plan Proponents elect to proceed with separate classifications for any such non-consolidated Classes of Claims and Interests, such Classes of Claims and Interests will be treated as against each individual non-consolidated Debtor for voting and distribution purposes. To provide for such an event, the Plan divides each Class of Claims and Interests into, subclasses; one for each of the Debtors, as set forth below.

PL - The Pacific Lumber Company  
BL - Britt Lumber Co., Inc.  
SC - Salmon Creek LLC  
SD - Scotia Development LLC  
SI - Scotia Inn Inc.  
SP - Scotia Pacific Company LLC

For example, Class 1 - "Other Priority Claims -- can be divided into six sub-classes for voting purposes: Class 1-PL, Class 1-BL ... through Class 1-SP. Class 1-PL relates to Other Priority Claims asserted against Palco, Class 1-BL relates to Other Priority Claims asserted against Britt, and so on. In some situations a particular Debtor may not have any claims asserted against it in a particular Class.

The classification of Claims and Interests, the estimated aggregate amount of Claims in each Class and the amount and nature of distributions to Holders of Claims or Interests in each Class are summarized in the table below. **Please read Section [\_\_\_] of this Disclosure Statement and Articles [IV and V] of the Plan for more detailed and complete information.**

No representation can be made that such information is without inaccuracy. Moreover, the information below is subject to the uncertainties of litigation with respect to many of the Claims and other factors that may not be resolved in the Debtors' favor. Therefore, no assurance can be given that the estimated Claims are exact or that the estimated recoveries will be achieved.



Unclassified Claims for All Debtors

In accordance with section 1123(a)(1) of the Bankruptcy Code, Administrative Expense Claims and Priority Tax Claims have not been classified. For a discussion of certain additional matters related to Administrative Expense Claims and Priority Tax Claims, see Section [4.5.]

Description and Estimate of Claims	Description of Distributions or Treatment Under the Plan	Estimated Aggregate Amount of Claims	Estimated Percentage Recovery
Administrative Expense Claims	<p>Allowed Professional Compensation Claims for Professionals employed pursuant to the Bankruptcy Code will be paid pursuant to applicable orders of the Bankruptcy Court.</p> <p>Allowed Administrative Expense Claims resulting from (a) post-petition liabilities incurred in the ordinary course of business by a Debtor or (b) post-petition contractual liabilities arising as a result of loans and advances (whether or not incurred in the ordinary course) will be paid in accordance with the terms and conditions of the particular transactions relating to such liabilities and any agreements relating thereto.</p> <p>All other Allowed Administrative Expense Claims will be paid in Cash on the later of (a) the Effective Date, or (b) the date on which each such Administrative Expense Claim is Allowed, unless the Holder agrees to other, lesser treatment.</p>	<p>PL-\$7.3 million                      BL-\$0                      SC-\$0                      SD-\$0                      SI-\$0                      SP-\$10 million  <b>Total: \$17.3 million</b></p>	100%
Priority Tax Claims	<p>Holders of Allowed Priority Tax Claims will receive Cash in the amount of such Allowed Claim (excluding interest).</p>	<p>PL-\$25,000                      BL-\$1,000                      SC-\$0                      SD-\$0                      SI-\$6,000                      SP-\$507,000  <b>Total: \$539,000</b></p>	100%

**CLASSIFIED CLAIMS AND INTERESTS FOR THE PALCO DEBTORS**

Description and Estimate of Claims	Description of Distributions or Treatment Under the Plan	Status/ Entitled to Vote	Estimated Aggregate Amount of Claims	Estimated Percentage Recovery
Class 1: Other Priority Claims	Holders of Allowed Other Priority Claims will receive: <ul style="list-style-type: none"> <li>i. payment of Cash in full, plus Post-petition Interest; or</li> <li>ii. such other, lesser treatment as the Reorganized Entities and the Holder may agree to in writing.</li> </ul>	<b>Unimpaired</b>  Deemed to Accept the Plan  Not Entitled to Vote	PL-\$884,000 BL-\$4,000 SC-\$0 SD-\$0 SI-\$0 SP-\$_____ <b>Total: \$605,000 to \$1,010,000</b>	100%
Class 2: Other Secured Claims	Holders of Allowed Other Secured Claims will receive: <ul style="list-style-type: none"> <li>i. payment of Cash in full, plus Post-petition Interest; or</li> <li>ii. such other, lesser treatment as the Reorganized Entities and the Holder may agree to in writing.</li> </ul>	<b>Unimpaired</b>  Deemed to Accept the Plan  Not Entitled to Vote	PL-\$0 BL-\$0 SC-\$0 SD-\$0 SI-\$0 SP-\$_____ <b>Total: \$0</b>	100%

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Description and Estimate of Claims	Description of Distributions or Treatment Under the Plan	Status/ Entitled to Vote	Estimated Aggregate Amount of Claims	Estimated Percentage Recovery
Class 3: Palco DIP Loan Claim	The Holder of an Allowed Class 3 Palco DIP Loan Claim and Allowed Class 4 Palco Term Loan Claim shall receive (1) 100% equity ownership interest of Townco, (2) [15%] equity ownership interest in Newco (subject to adjustment), and (3) a note from Newco in the approximate amount of \$25 million secured solely by Liens on the Mill Working Capital.	<b>Impaired</b>  Entitled to Vote to Accept or Reject the Plan	PL-\$75.3 million BL--\$75.3 million SC--\$75.3 million SD--\$75.3 million SI--\$75.3 million <b>Total: \$75.3 million</b>	____%
Class 4: Palco Term Loan Claim	The Holder of an Allowed Class 3 Palco DIP Loan Claim and Allowed Class 4 Palco Term Loan Claim shall receive (1) 100% equity ownership interest of Townco, (2) [15%] equity ownership interest in Newco (subject to adjustment), and (3) a note from Newco in the approximate amount of \$25 million secured solely by Liens on the Mill Working Capital.	<b>Impaired</b>  Entitled to Vote to Accept or Reject the Plan	PL-\$87.1 million BL-\$87.1 million SC-\$87.1 million SD-\$87.1 million SI-\$87.1 million <b>Total: \$87.1 million</b>	____%

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Description and Estimate of Claims	Description of Distributions or Treatment Under the Plan	Status/ Entitled to Vote	Estimated Aggregate Amount of Claims	Estimated Percentage Recovery
Class 5: Scopac Loan Claim	<p>On the Distribution Date, the Holder of the Allowed Scopac Loan Claim, shall receive</p> <p>Holders of Allowed Other Secured Claims will receive:</p> <ul style="list-style-type: none"> <li>i. payment of Cash in full, plus Post-petition Interest; or</li> <li>ii. such other, lesser treatment as the Reorganized Entities and the Holder may agree to in writing.</li> </ul>	<p><b>Unimpaired</b></p> <p>Deemed to Accept the Plan</p> <p>Not Entitled to Vote</p>	\$37.6 million	100%
Class 6: Scopac Timber Note Secured Claims	<p>Each Holder of an Allowed Scopac Timber Note Secured Claims shall receive its Pro Rata share of \$175 million in Cash plus its Pro Rata share of New Timber Notes in the principal amount of \$325 million accruing interest at 5.5% per annum and secured by the Timberlands as more fully set forth in the Plan; or, to the extent that this Class 6 makes an election pursuant to section 1111(b)(1)(A)(i) of the Bankruptcy Code, each Holder of an Allowed Scopac Timber Note Secured Claim shall receive the treatment described in the Plan.</p>	<p><b>Impaired</b></p> <p>Entitled to Vote to Accept or Reject the Plan</p>	\$800 million	62.5%

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Description and Estimate of Claims	Description of Distributions or Treatment Under the Plan	Status/ Entitled to Vote	Estimated Aggregate Amount of Claims	Estimated Percentage Recovery
Class 7: Palco Trade Claims	Each Holder of an Allowed Palco Trade Claim and Allowed Scopac Trade Claim shall receive, together with Allowed Scopac Trade Claims, Allowed Palco General Unsecured Claims and Allowed Scopac General Unsecured Claims, its Pro Rata share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.	<b>Impaired</b>  Entitled to Vote to Accept or Reject the Plan	PL-\$___ million BL-\$___ million SC-\$___ million SD-\$___ million SI-\$___ million <b>Total: \$___ million</b>	75%
Class 8: Scopac Trade Claims	Each Holder of an Allowed Palco Trade Claim shall receive, together with Allowed Palco Trade Claims, Allowed Palco General Unsecured Claims and Allowed Scopac General Unsecured Claims its Pro Rata share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.	<b>Impaired</b>  Entitled to Vote to Accept or Reject the Plan	\$_ million	75%
Class 9: Timber Note Unsecured Claims	Each Holder of an Allowed Timber Note Unsecured Claim shall receive its applicable Litigation Trust Participation.	<b>Impaired</b>  Entitled to Vote to Accept or Reject the Plan	\$300 million	Unknown

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Description and Estimate of Claims	Description of Distributions or Treatment Under the Plan	Status/ Entitled to Vote	Estimated Aggregate Amount of Claims	Estimated Percentage Recovery
Class 10: Palco General Unsecured Claims	Each Holder of an Allowed Palco General Unsecured Claim shall receive, together with Allowed Palco Trade Claims, Allowed Scopac Trade Claims and Allowed Scopac General Unsecured Claims, its Pro Rata share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.	<b>Impaired</b> Entitled to Vote to Accept or Reject the Plan	PL-\$__ million BL-\$__ million SC-\$__ million SD-\$__ million SI-\$__ million <b>Total: \$__ million</b>	Unknown
Class 11: Scopac General Unsecured Claims	Each Holder of an Allowed Scopac General Unsecured Claim shall receive, together with Allowed Palco Trade Claims, Allowed Scopac Trade Claims and Allowed Palco General Unsecured Claims, its Pro Rata share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.	<b>Impaired</b> Entitled to Vote to Accept or Reject the Plan	\$__ million	Unknown

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Description and Estimate of Claims	Description of Distributions or Treatment Under the Plan	Status/ Entitled to Vote	Estimated Aggregate Amount of Claims	Estimated Percentage Recovery
Class 12: Inter-Debtor Claims	Inter-Debtor Claims shall be discharged and the Holders of Inter-Debtor Claims are not entitled to Distributions	<b>Impaired</b> Deemed to Reject the Plan Not Entitled to Vote	PL-\$___ million BL-\$___ million SC-\$___ million SD-\$___ million SI-\$___ million SP-\$___ <b>Total: \$___ million</b>	0%
Class 13: Non-Debtor Affiliate Claims	Non-Debtor Affiliate Claims shall be discharged and Holders of Non-Debtor Affiliate Claims are not entitled to Distributions	<b>Impaired</b> Deemed to Reject the Plan Not Entitled to Vote	Maxxam Entities-\$_____	0%
Class 14: Interests in the Debtors	Interests in the Debtors shall be discharged and Holders of Interests in the Debtors are not entitled to Distributions	<b>Impaired</b> Deemed to Reject the Plan Not Entitled to Vote	PL-unknown Maxxam Entities-unknown	0%

**SECTION 1.  
GENERAL INFORMATION AND HISTORICAL BACKGROUND**

**1.1. The Debtors' 140-Year History**

The Debtors trace their roots back to 1863, during an era when the Civil War was raging, the Pony Express was just being replaced by the transcontinental railroad, and Arizona had just become a U.S. Territory. That same year, A. W. McPherson and Henry Wetherbee bought 6,000 acres of land along the Eel River in Humboldt County, California for \$1.25 per acre. It was the beginning of what would one day become Palco.

Over the next 20 years, McPherson and Wetherbee took on new partners, bought more land, and built sawmills and shipping facilities. In 1882, they began logging operations in Humboldt County and started building the town of Forestville, which would serve as the company's headquarters and provide housing for its employees. A few years later, the town's name was changed to Scotia.

By 1888, McPherson's and Wetherbee's original vision had become a reality. Palco had 300 employees and was shipping 20 million board feet a year, making the company the largest producer of lumber in Humboldt County. The town of Scotia began to grow and prosper, boasting a post office, a Western Union station, its own school district, and a church.

**1.2. Business Activities of the Debtors.**

**(a) Overview of the Debtors' Businesses.**

The Debtors are one of the largest producers of redwood lumber in the State of California. The Debtors own and manage approximately 210,000 acres of commercial timberlands located in Humboldt County along the northern California coast, an area with very favorable soil and climate conditions for growing timber.

Lumber is the principal product of the Debtors. The Debtors normally offer a variety of lumber, including different grades of redwood and Douglas-fir. The availability of timber for harvest depends in large part upon the ability to obtain regulatory approval of THPs prepared by Scopac's foresters. The housing, construction and remodeling markets are the primary markets for the Debtors' lumber products. Their accounts are primarily wholesale, followed by industrial end users, manufacturers, retailers and exporters.

The Mill is located in Scotia, California and was consists of a sawmill, lumber, marketing and distribution operations. As noted above, the Debtors once operated five sawmills, but have since consolidated them into the one sawmill that was constructed in 2006.

The Debtors own substantially all of the assets in the town of Scotia, California, including industrial use facilities, a co-generation plant, 270 homes, various commercial properties, and all of the land associated with these assets. Many of the Debtors' employees live



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in Scotia. The Debtors also own a sawmill in Arcata, California but that sawmill is in the process of being shut down and sold. The Debtors derive some revenue from a variety of sources other than commercial forestry, such as the sale of electricity from its co-generation plant, the sale of wood chips and logs, and the lease of various residential and commercial properties.

### **(b) Overview of the Timber Industry.**

#### **(1) Timber Generally.**

Timber generally is categorized by species and the age of a tree when it is harvested. "Old-growth trees are often defined as trees that have been growing for approximately 200 years or longer, while younger trees typically are called "young growth or "second growth. The forest products industry grades lumber into various classifications according to quality. Based on the absence or presence of knots, all grades of lumber fall into two broad categories: "upper and "common. Old-growth trees have a higher percentage of upper-grade lumber than young-growth trees.

The Debtors' merchantable timber is comprised of redwood, Douglas fir and other conifer timber. The conifers consist (by volume) of approximately 66% redwood, 30% Douglas fir and 4% other conifer timber.

#### **(2) Timber Operations in Northern California.**

California law requires large timberland owners demonstrate that their timber operations will not decrease the sustainable productivity of their timberlands. The applicable regulations require timber companies to project timber growth and harvest on their timberlands over a 100-year planning period and to demonstrate sustained yield. "Sustained yield means that their projected average annual harvest for any decade within the 100-year planning period will not exceed the average annual growth level at the end of the 100-year planning period. A timber company may comply with this requirement by submitting a sustained yield plan to the CDF, the California Department of Forestry and Fire Protection, for review and approval or by following alternative procedures. Federal and state laws also provide for the protection and conservation of wildlife species that have been designated as endangered or threatened, certain of which are found on the Timberlands. See "Regulatory and Environmental Factors below.

### **(c) Harvesting Practices.**

#### **(1) Regulatory Approval of Timber Harvest Plans.**

Before harvesting timber in California, companies must obtain the approval of the CDF for a detailed THP, or timber harvest plan, for the area to be harvested. A THP must be submitted by a Registered Professional Forester and must include, among many other things, information regarding the method of proposed timber operations for a specified area, whether the operations will have any adverse impact on the environment and, if so, the mitigation measures to be used to reduce the impact. The CDF's evaluation of THPs incorporates review and analysis by several California and federal agencies as well as the review of public comments. The number of the

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Debtors' approved THPs and the amount of timber they cover can vary significantly from time to time, depending on the timing of agency review and other factors. Timber covered by an approved THP typically is harvested within a one-year period after harvesting begins.

### **(2) Selections for Harvest.**

The Debtors maintain an information system covering the Timberlands. The Debtors' geographical information system covers numerous aspects of their timber properties, including timber type, site productivity class, wildlife and botanical data, geological information, roads, rivers and streams. By monitoring and updating this data base and conducting field studies, the Debtors are better able to develop detailed THPs addressing various regulatory requirements, including those contained in the HCP, or Habitat Conservation Plan, applicable to substantial portions of the Timberlands.

### **(d) Production Facilities.**

#### **(1) Overview of the Mill.**

Palco once operated five sawmills, but has since consolidated them into one high speed Mill in Scotia. Britt owns a sawmill in Arcata, California that, as noted above, has been idled, and the fence processing portion of Britt's operations has been moved to Scotia.

#### **(2) Lumber Drying.**

The Debtors dry a portion of their lumber before it is processed or sold. Air or kiln-dried lumber generally commands higher prices than "green lumber, which is lumber sold before it has been dried. Drying also allows the Debtors to compete in additional markets due to lower shipping costs resulting from the moisture and weight reduction that occurs in the drying process. The Debtors own and can operate up to 31 kilns having an annual capacity of approximately [redacted] million board feet.

#### **(3) Co-Generation Plant.**

The Debtors own and operate a cogeneration power plant that is fueled by the wood residue from logging and lumber production operations and third-party purchases. The power plant generates substantially all of the energy requirements of Scotia and sells surplus power to Pacific Gas and Electric Company.

### **(e) Lumber Sales.**

#### **(1) The Primary Markets.**

The housing, construction and remodeling markets are the primary markets for the Debtors' lumber products. The Debtors' customers are primarily wholesale, followed by industrial end users, manufacturers, retailers, and exporters.

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The following table sets forth the distribution of lumber production by the Debtors (on a net board-foot basis) and revenues by product line during 2006:

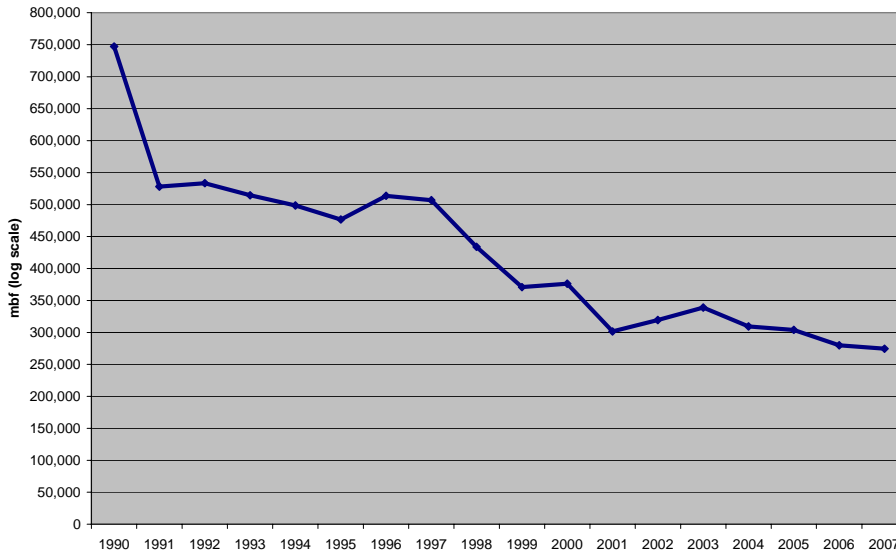
<b>Product</b>	<b>Year Ended December 31, 2006</b>		
	<b>% of Total Lumber Production Volume</b>	<b>% of Total Lumber Revenues</b>	<b>% of Total Revenues</b>
Upper grade redwood lumber	2%	5%	4%
Common grade redwood lumber	66%	76%	66%
Total redwood lumber	68%	81%	70%
Upper grade Douglas-fir lumber	--	--	--
Common grade Douglas-fir lumber	32%	19%	17%
Total Douglas-fir lumber	32%	19%	17%
Other grades of lumber	--	--	--
Total lumber	<u>100%</u>	<u>100%</u>	<u>87%</u>
Logs			<u>3%</u>
Wood Chips			<u>2%</u>

**(2) Redwood Lumber.**

Redwood lumber has historically has been the Debtors' best selling product. Redwood is commercially available only along the northern coast of California. The Debtors own and manage approximately 210,000 acres of commercial timberlands. Commercial and private ownership of redwood forestlands is estimated today at 1.3 million acres. Another 350,000 acres is owned by federal, state and local governments and conservation groups, including 86,000 acres (approximately 125 square miles) of old growth forest that have been preserved permanently.

Redwood timber harvesting has been declining for an extended period of time. Since 1990, annual redwood harvest has declined by 63%:

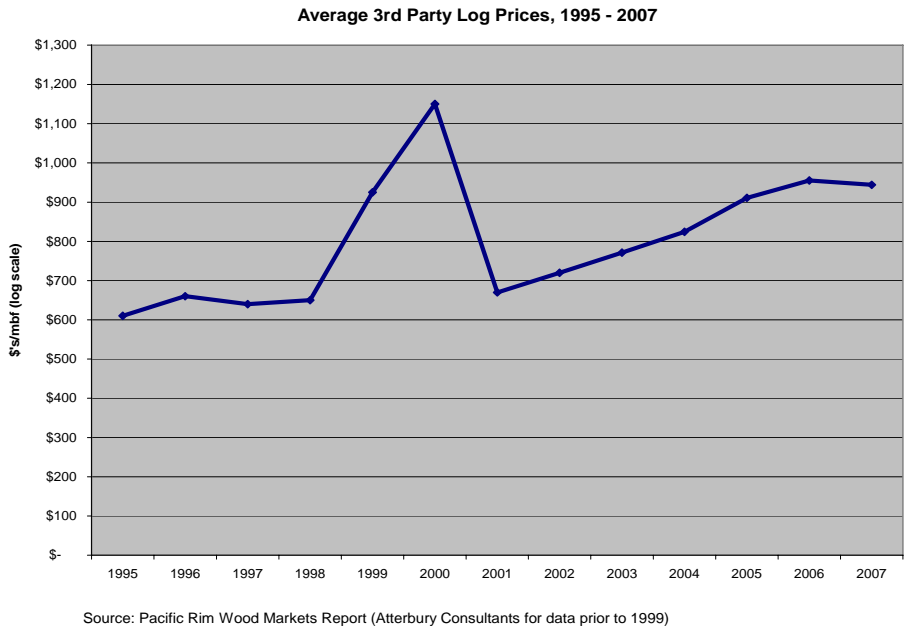
Figure 1: Redwood Harvest Volumes, 1990 - 2007



Source: Historical reports by the California Board of Equalization and(2007 Projection by MRC

This decline is caused largely by historic harvesting at rates in excess of the growth in standing inventory of the forest, and to a lesser degree, due to increasing regulatory restrictions over time.

In the short-term, pricing for third party log sales is a function of log and lumber inventories at saw mills. In the long-term, log prices are tied to lumber prices. The log price run up of 2000 was in response to mill concerns that no logs would be available due to disruptions in harvest associated with the Headwaters Agreement. Mills quickly learned that consumers would not pay for lumber based on log prices inflated by supply concerns of that period. Following the price decline of redwood logs in 2001 (see graph below), redwood log prices have risen gradually, until the recent slump in housing construction in mid 2007.



Separate and apart from the overall redwood log and lumber markets, it appears that log prices in Humboldt County were inflated in 2004, 2005 and 2006 and the first half of 2007 due to the demands of the Mill operating on 2 shifts, which exceeded the natural supply of logs from the economic wood basket. This can be seen on the following table:

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	Estimated Small Log Prices at the mill <sup>1</sup> by County (\$'/mbf, log scale)			Estimated Small Log Prices net to landowner (stumpage) <sup>2</sup> by County (\$'/mbf, log scale)		
	Humboldt	Mendocino	Humboldt Premium <sup>3</sup>	Humboldt	Mendocino	Humboldt Premium <sup>3</sup>
	Jan-98	730	710	20	570	540
Jul-98	741	750	(9)	580	570	10
Jan-99	740	750	(10)	580	570	10
Jul-99	860	850	10	700	670	30
Jan-00	1,025	1,070	(45)	870	900	(30)
Jul-00	1,355	1,435	(80)	1,200	1,200	-
Jan-01	1,175	1,226	(51)	1,000	1,000	-
Jul-01	781	875	(94)	600	650	(50)
Jan-02	692	718	(26)	500	500	-
Jul-02	627	680	(54)	420	460	(40)
Jan-03	671	702	(31)	450	480	(30)
Jul-03	765	792	(27)	550	570	(20)
Jan-04	831	811	20	620	570	50
Jul-04	846	816	30	630	580	50
Jan-05	932	887	45	720	640	80
Jul-05	970	938	32	750	680	70
Jan-06	1,012	967	45	790	690	100
Jul-06	1,013	958	55	780	680	100
Jan-07	1,038	991	47	790	700	90
Jul-07	969	932	37	720	650	70
Jan-08	1,014	978	36	750	660	90
<b>Average, Jan-04 to Jan-08</b>			<b>39</b>			<b>78</b>
<b>Notes:</b>						
<sup>1</sup> "Small" logs are 15" or less in diameter. Prices shown at the mill are based upon "stumpage" prices reported by California Board of Equalization, plus estimated average costs to "log & haul" the timber.						
<sup>2</sup> "Stumpage" is the log price paid, net of the costs to harvest ("log") and deliver ("haul") the logs to a mill.						
<sup>3</sup> "Premium" refers to the difference between Humboldt prices and Mendocino prices.						

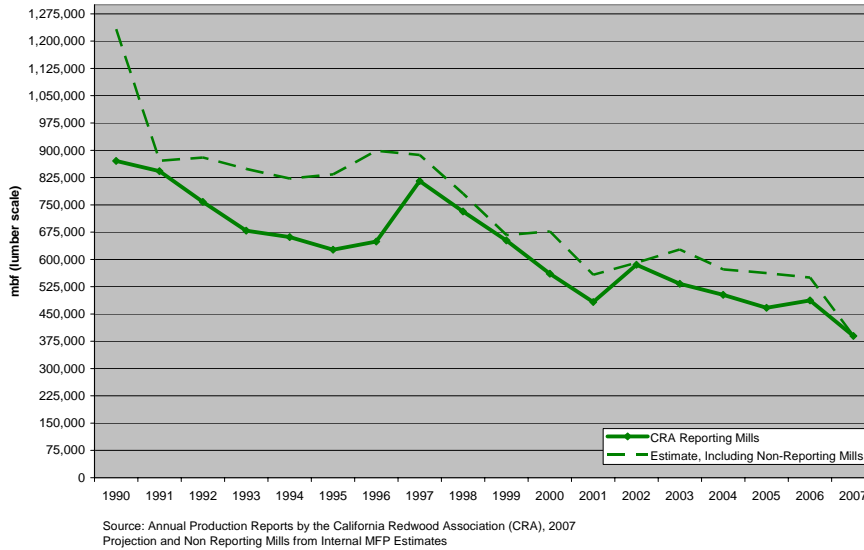
Source: California State Board of Equalization

The table indicates that landowners in Humboldt County received on average \$78 per million board feet more for small redwood logs than their counterparts in Mendocino County from July 2004 through July 2007. The table also indicates that sawmills in Humboldt County paid \$39 per million board feet more than sawmills in Mendocino County for the same period.

Based on Scopac total redwood harvest rates of just under 250 million board feet for the period July 2004 through June 2007, it would appear that the Mill paid to Scopac roughly \$10 million more in aggregate dollars for small redwood logs than was paid by comparable mills in Mendocino County for the same logs. Similarly, Scopac appears to have received roughly \$20 million more in aggregate dollars for its logs relative to what Mendocino County landowners were receiving for the same logs during the same period.

Redwood region sawmill production of redwood lumber has declined along with the decline in redwood log harvests:

Figure 2: Redwood Lumber Production, 1990 - 2007



**(3) Douglas-Fir Lumber.**

Douglas-fir lumber is used primarily for new construction and some decorative purposes and is widely recognized for its strength, hard surface and attractive appearance. Douglas-fir timber is grown commercially along the west coast of North America and in Chile and New Zealand. Upper-grade Douglas-fir lumber is derived primarily from larger-diameter Douglas-fir timber and is used principally in finished carpentry applications. Common-grade Douglas-fir lumber is used for a variety of general construction purposes and is somewhat interchangeable with common grades of other whitewood species, although the strength of Douglas fir makes it more desirable in certain applications.

**(4) Log Purchases.**

During 2006, the Debtors purchased approximately one-third of its logs ([redacted] million board feet) from third parties. The Debtors do not have any significant long-term contractual relationships with third parties relating to the purchase of logs. The Debtors produce softwood chips from the wood residue from its milling operations. Palco sells these chips to third parties for the production of wood pulp and paper products. Subject principally to economic feasibility, Palco also produces and sells wood chips from hardwood trees to third parties.

**(5) Use of Redwood.**

Almost 90% of all redwood lumber produced is consumed in the construction of residential decks and fences. The demand for deck and fence construction is driven by 3 key factors, in order of their impact: (i) repair/replacement of existing decks and fences as they age; (ii) remodeling additions to existing residences, and (iii) new housing starts. The recent decline in new housing construction and the contraction of real estate credit can be expected to have a negative effect on the demand drivers for decks and fences for at least the next two years.

Other uses of redwood are for specialty consumer products such as garden treatments, play sets, outdoor furniture, and decorative trim. Ultra high grade redwood, representing less than 5% of potential yield, has application as a premium interior finishing material in significant architectural projects as exposed beams, timbers, paneling, and siding.

Nationwide, the 2005 market value for decking surface materials is estimated to be over \$5 billion. However, on a national basis, redwood now accounts for less than 5% of the market for decking and fencing materials.

**(6) Competition.**

The Debtors sell their lumber in highly competitive markets. Competition generally is based on a combination of price, service, product availability, product quality and competition with other products.

Consumers enjoy a greater selection of materials to use in creating their decks and fences than ever before. The principal materials competing with redwood are: pressure treated lumber, wood/plastic composites (e.g. Trex), plastics, Western red cedar and tropical hardwoods (including ipe, cumaru, mahogany and teak).

Pressure treated lumber, typically southern yellow pine, is the most popular decking material outside of California. This material garnered 72.4% of the national decking market in 2006. What pressure treated lumber lacks in beauty and appearance seems to be offset by its low cost, availability, and ease of use in the minds of consumers. Retailers almost always position treated lumber as their "economy" or "good" offering among decking options.

Wood/plastic composites ("WPC") such as Trex are the fastest growing competitive material to redwoods. WPC is an engineered material manufactured from a mixture of wood flour waste, purchased from furniture makers, and recycled polyethylene from plastic milk jugs and garbage bags. From the inception of this technology in the mid-1990s, WPC market share has risen to 11.8% (2006 estimate) of the National decking marketing. Manufacturers of WPC have historically spent tens of millions each year on brand building and promotion; far in excess of the entire promotional budget of the California Redwood Association (which spent only \$150,000 in 2006). Consumers favor WPC's perceived low maintenance and long life. Most retailers position WPC as the premium or "best" category of decking.

Decking material made completely from plastic, such as eOn, began to emerge in the marketplace in response to the success of WPCs. Plastic decking is usually fabricated from virgin or recycled polyvinylchloride (PVC). At 2006, industry analysts estimated that plastic decking had captured 2.7% of the national market. Plastic decking is usually positioned as the "better" or "best" choice in retail assortments.

Western red cedar is primarily fueled by Canadian imports. Consumers perceive this material as comparable to redwood but more readily available due to its wider growing region.



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Positioned by most retailers as a "better" category of decking material, Western red cedar enjoys a national market share of approximately 6.4%.

Tropical hardwoods comprise 2.1% of the national marketing owing to their limited availability. These materials are also very difficult to fabricate into decks, often requiring pre-drilling and special saw blades in the construction process. Retailers tend to position these materials as "exotic" or "luxury" and price them at a significant premium

The level of demand for the companies' products is dependent on such broad factors as overall economic conditions, interest rates, and demographic trends. In addition, competitive considerations, such as total industry production and competitors' pricing, as well as the price of other construction products, affect the sales prices for their lumber products. Competition in the common-grade redwood and Douglas-fir lumber market is intense, with numerous large and small lumber producers. Palco and Britt primarily compete with the northern California mills of Simpson, Redwood Empire, Sierra Pacific, and Canadian cedar lumber producers, as well as other imports and non-wood alternatives.

### **(7) Customer Concentration.**

As harvest volumes declined over the years, the distribution network for redwood lumber has naturally contracted in scope. The former nationwide network has become regionalized into the western US. In 2006, 83% of all redwood lumber was sold within the state of California. The next largest redwood consuming state was Colorado which accounted for 3.6% of redwood sales volume.

Traditionally, redwood lumber was sold by the producing mills to stocking distributors who, in turn, sold the lumber at wholesale prices to retail lumber yards, including small regional retail chains. Since 1996, "big box" retailers, such as the Home Depot and Lowes, began to purchase redwood directly from mill operators. The industry's on-going transition from the traditional "three step" distribution network to the big box "two step" network requires new technology and skills. Today's large retailers demand rapid response capabilities, warehouse management systems, logistics systems, and a depth of customer service and merchandizing support not available at traditional redwood mill operations.

As the distribution channel for redwood continues to evolve and consolidate, the surviving stocking distributors and big box retailers also look for advantages from consolidated shipments to service their locations. Single product (redwood only) line suppliers such as the Debtors are poorly positioned to capitalize on this trend.

### **(8) Price Fluctuations and Seasonality.**

First-quarter lumber sales historically have been lower due largely to the general decline in construction related activity during the winter months. The demand for lumber is also being affected negatively by the lower level of new construction, remodeling and renovation activity. These activities are, in turn, subject to fluctuations due to, among other factors:

- changes in domestic and international economic conditions;

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- interest rates or the availability of financing;
- population growth and changing demographics; and
- seasonal weather cycles (e.g., dry summers, wet winters) and other weather-driven events.

Decreases in the level of residential construction activity or repair and remodeling activity generally reduce demand for logs and wood products. In addition, timber owners generally increase production volumes for logs and products during favorable price environments. Such increased production could, when coupled with declines in demand for these products in general, lead to oversupply and lower prices.

**(9) Current Market Conditions.**

The current housing slow-down and overall unfavorable economic trends have and will continue to negatively affect the Debtors. According to the California Redwood Association, redwood lumber sales in 2007 were down 20% compared to 2006. However, MRC expects the California Board of Equalization to report that 2007 redwood log harvest levels declined by only a modest 2% from 2006 levels. It is estimated that total redwood log inventories have increased by 22% in 2007 when compared to 2006.

On a short term basis, significant declines in lumber sales without corresponding declines in log harvest will lead to large increases in log and lumber inventories. Large increases in log and lumber inventory combined with weak end-consumer demand have lead to declines in log and lumber prices.

**(f) Regulatory and Environmental Factors.**

**(1) General.**

The Debtors' commercial timberland operations are subject to a variety of California and federal laws and regulations, as well as the comprehensive multi-species HCP, dealing with timber-harvesting practices, threatened and endangered species and habitat for such species, and air and water quality. Compliance with such laws and regulations also has played a significant role in the Debtors' businesses. The California Forest Practice Act and related regulations adopted by the CDF set forth detailed requirements for the conduct of timber-harvesting operations in California. These requirements include the obligation of timber companies to obtain regulatory approval of THPs containing detailed information about areas proposed to be harvested. California law also requires large timberland owners such as the Debtors to demonstrate that their proposed timber operations will result in (but not exceed) the maximum sustainable production of their timberlands over time.

The Debtors are subject to the federal Endangered Species Act and the California Endangered Species Act, which provide in general for the protection and conservation of specifically listed wildlife and plants. The Debtors are also subject to the California Environmental Quality Act, which provides for protection of the state's air and water quality and

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wildlife, and the California Porter-Cologne Water Quality Control Act and federal Clean Water Act, which require that the Debtors conduct operations so as to reasonably protect the water quality of nearby rivers and streams. Compliance with such laws and related regulations and judicial and administrative interpretations, together with other regulatory and environmental matters, have resulted in substantial restrictions on the scope and timing of harvesting and other operations on the Timberlands.

As indicated above, forestry in California is a highly regulated activity. Regulation has evolved as a result of California environmental laws that have, over a long period of time, required increased public disclosure of forestry related activities as compared to other states. The California mandated disclosure has led to greater application of federal environmental laws in California as compared to other states on privately held forest lands. Greater application of federal environmental laws has in turn often led to additional state environmental laws, and the disclosure process has created a cycle of ever increasing forestry regulation over time.

The following Federal, State and local regulatory agencies all have regulatory authority over the Debtors:

- Federal
  - US Fish and Wildlife Service
  - National Marines Fisheries Service (NOAA)
  - Army Corp of Engineers
  - Federal Environmental Protection Agency
- State
  - Cal Fire (formerly California Department of Fire and Forestry Protection)
  - California State and Regional Water Quality Control Boards
  - California State and Regional Air Quality Control Boards
  - State Environmental Protection Agency
  - Cal Trans (Department of Transportation)
  - California Dept of Fish and Game
  - California Dept of Mines and Geology
  - California Board of Forestry
- County
  - County Planning Departments (in Counties with commercial timberlands)
  - County Transportation Departments
  - County Ag Commissioner's Office

The regulatory system for California forestry is considered challenging, as these varied federal, state and county agencies all regulate independently. However, most of these agencies predominately coordinate their actions through two agencies, Cal Fire (whose decisions can be appealed to the California Board of Forestry) and the California State and Regional Quality Control Boards (whose decisions cannot easily be appealed under California law).

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The Debtors have not only experienced the same significantly increased operational costs as a result of increasing environmental regulations as operators have experienced. The Debtors have a generally poor relationship with their regulators and with the environmental community in general. Indeed, the Debtors have engendered continual litigation with their regulators and, as a result, face unique regulatory challenges to their operations.

### **(2) Environmental Plans.**

As noted above, the Debtors are subject to the federal and California Endangered Species Acts, which provide for the protection and conservation of wildlife species that have been designated as endangered or threatened, certain of which are found on the Timberlands. These laws generally prohibit certain adverse impacts on such species (referred to as a "take"), except for incidental take that does not jeopardize the continued existence of the affected species and occurs as a result of operations that comply with an approved habitat conservation plan and related ITP, or incidental-take permit. A habitat conservation plan analyzes the impact of the incidental take and specifies a procedure to monitor, minimize and mitigate the impact. As part of the Headwaters Agreement described in Section 1.3, the federal and state governments approved the HCP covering substantially all of the Timberlands and related state and federal ITPs in connection with certain Environmental Plans.

The federal and state governments also approved the SYP, a sustained yield plan, for the Debtors that satisfied the State of California's requirement that timberland owners demonstrate that their timber operations will not decrease the sustainable productivity of their timberlands. In December 2005, a California appellate court reversed a trial court decision that had invalidated the Debtors' SYP and the ITPs issued by California in connection with the Environmental Plans that were approved as part of the Headwaters Agreement. The plaintiffs appealed the appellate court decision to the California Supreme Court, which has accepted the appeal for review. See Section [3.1] for further information regarding this matter. As a result of the trial court's decision, Scopac from October 2002 until March 2005, obtained review and approval of its THPs under an alternative procedure in the California forest practice rules known as "Option C. Option C is available to landowners who, like the Debtors, have submitted an "Option A plan to the CDF for review. An approved Option A plan is an alternative to obtaining approval of sustained yield plan. The CDF approved Palco's Option A plan in March 2005. Scopac currently is relying upon the Option A plan to obtain THP approvals.

In connection with approval of the Environmental Plans, California and federal agencies issued ITPs with respect to certain threatened, endangered, and other species found on the Timberlands. The permits were to cover the 50-year term of the HCP and allow incidental take of 17 different species covered by the HCP, including nine species which are found on the Timberlands that have been listed under the federal Endangered Species Act and/or the California Endangered Species Act. The agreements that implement the Environmental Plans also provide for various remedies (including the issuance of written stop orders and liquidated damages) in the event of a breach by the Debtors of these agreements or the Environmental Plans.

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Under the HCP, harvesting activities are prohibited or restricted on certain areas of the Timberlands. Some of these restrictions continue for the entire 50-year term of the HCP. For example, several areas (containing substantial quantities of timber, including old-growth redwood and Douglas-fir timber) are designated as habitat conservation areas for the marbled murrelet, a coastal seabird, and certain other species. Harvesting in certain other areas of the Timberlands currently is prohibited while these areas are evaluated for the potential risk of landslide. Further, additional areas alongside streams have been designated as buffers, in which harvesting is prohibited or restricted in order to protect aquatic and riparian habitat. Restrictions on harvest in streamside buffers and potential landslide-prone areas may be adjusted up or down, subject to certain minimum and maximum buffers, based on the ongoing watershed-analysis process described below. The adaptive-management process described below may also be used to modify most of these restrictions.

The first analysis of a watershed, Freshwater, was released in June 2001. This analysis was used by the Debtors and the government agencies to develop proposed harvesting prescriptions. Since then, watershed analysis has been completed and prescriptions approved for four additional watersheds: Van Duzen in January 2004, Lower Eel-Eel Delta in March 2004, Elk River in November 2005, and Upper Eel in March of 2007. In addition, prescriptions for the Bear River watershed have been tentatively approved by the agencies pending completion of an analysis of the effects of these prescriptions on terrestrial wildlife. The Freshwater, Van Duzen, Lower Eel, Elk River, Upper Eel, and Bear River prescriptions each resulted in a reduction in the size of the streamside buffers set forth in the Environmental Plans and also provide for geologic reviews in order to conduct harvesting activities on some potential landslide-prone areas in lieu of no-harvest restrictions. This effectively reduced both constrained acreage and HCP-related operational restrictions in these watersheds.

The HCP required the Debtors, together with the government agencies, to establish a schedule resulting in completion of the initial watershed-analysis process for all covered lands within five years. However, due largely to the number of agencies involved and the depth and complexity of the analyses, the process has required significantly more time than originally anticipated. Accordingly, the Debtors continue to work with the government agencies to establish appropriate timelines and to streamline watershed analyses on the remaining portions of Timberlands to ensure that such studies are both time and cost efficient and continue to provide scientific results necessary to evaluate potential changes to the harvesting restrictions on those lands. The Debtors had previously received an extension to March 2007 for completion of the watershed-analysis process. An additional request for an extension to March 2008 was submitted to the HCP agencies. The Debtors are currently working under that extension and hope to be completed by March 2008 or soon thereafter.

The HCP contains an adaptive-management provision that allows the Debtors to propose changes to many of the HCP prescriptions. The Debtors and the agencies have previously implemented various adaptive-management changes related to wildlife and rare plants, and other changes relating to roads and streamside buffers. These adaptive-management changes have increased the ability to conduct harvesting operations on the Timberlands or reduced operating costs while still meeting the obligations of the Environmental Plans.

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The HCP imposes certain restrictions on the use of roads on the timberlands covered by the HCP during several months of the year and during periods of wet weather. However, Palco has conducted, and expects to be able to continue to conduct, some harvesting during these periods. An adaptive-management change approved in 2003 for the road restrictions has improved the ability to construct and use roads on the Timberlands in ways that are consistent with the Debtors' operational needs. The HCP also requires that 75 miles of roads be storm proofed (i.e., reconstructed to reduce sediment generation) on an annual basis and that certain other roads must be improved or repaired. This work is feasible only in the dry periods of the year.

### **(3) Water Quality.**

Laws and regulations dealing with water quality affected or have the potential further to affect the Debtors primarily in three areas: (1) efforts by the EPA and the North Coast Water Board to establish total maximum-daily-load limits in watercourses that have been declared to be water-quality impaired; (2) the North Coast Water Board's imposition of waste-discharge reporting requirements, as well as various mitigation, erosion control, and clean-up measures; and (3) the development by the North Coast Water Board and its staff of special permitting requirements for the Freshwater and Elk River watersheds known as watershed-wide waste discharge requirements or WWDRs.

The Federal Clean Water Act requires the EPA to establish total maximum daily levels, or TMDLs, in watercourses that have been declared to be water-quality impaired. The EPA and the North Coast Water Board are in the process of establishing TMDLs for many northern California rivers and certain of their tributaries, including nine watercourses that flow within the Timberlands. The relevant contaminant on the Timberlands is simple sediment-dust, dirt, and gravel-that is abundant in watercourses largely as a function of the area's normally heavy rainfall and easily eroded soil. Palco expects the process of establishing TMDLs to continue into 2010. The EPA has issued a report dealing with TMDLs on three of the nine watercourses in the Timberlands. The agency indicated that the requirements under the HCP would significantly address the sediment issues that resulted in TMDL requirements for these watercourses. The North Coast Water Board is now in the process of establishing the TMDL requirements applicable to two other watercourses, Freshwater and Elk River, with a targeted completion of 2008. Scopac's scientists are working actively with North Coast Water Board staff to ensure that these TMDLs recognize and incorporate the environmental protection measures of the HCP. The final TMDL requirements applicable to the Timberlands may require aquatic protection measures that are different from or in addition to those in the HCP or that result from the prescriptions to be developed pursuant to the watershed analysis process provided for in the HCP. These requirements could further restrict harvesting on the Timberlands.

For each of the winter periods since 2002, Palco and Scopac have been required to submit reports on sediment discharges and erosion-control practices to the North Coast Water Board in order to conduct winter harvesting operations in the Freshwater and Elk River watersheds. After consideration of these reports, the North Coast Water Board imposed requirements on the Debtors to implement additional mitigation and erosion-control practices in these watersheds for each of these winter operating periods. The North Coast Water Board has also extended the requirements for certain mitigation and erosion-control practices in three additional watersheds

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(Bear, Jordan, and Stitz Creek). The Debtors and the North Coast Water Board are currently in discussions to determine what these measures will be. The requirements imposed to date by the North Coast Water Board have significantly increased operating costs; additional requirements imposed in the future could further increase costs and cause additional delays in THP approvals.

The North Coast Water Board also has issued clean-up and abatement orders for the Freshwater and Elk River watersheds, which are aimed at addressing existing sediment production sites through clean-up actions. The North Coast Water Board has also initiated a process that could result in similar orders for the Bear Creek watershed and is contemplating similar actions for the Jordan and Stitz Creek watersheds. The clean-up and abatement orders for the Freshwater and Elk River have resulted in increased costs that could extend over a number of years. Additional orders for other watersheds (should they be issued) may also result in further cost increases.

On May 8, 2006, the North Coast Water Board adopted WWDRs for the Freshwater and Elk River watersheds. The decision allowed harvesting in these two watersheds, up to approximately 50% of the CDF Harvest Limit, once the staff of the North Coast Water Board reviews and enrolls THPs submitted by Scopac. The North Coast Water Board's decision also allowed the enrollment of additional THPs, bringing the total to approximately 75% of the CDF Harvest Limit for these two watersheds, upon approval of a monitoring and reporting program by the Executive Officer of the North Coast Water Board staff. The monitoring and reporting program was approved in September 2006, allowing enrollment by the staff of the North Coast Water Board of additional THPs for these two watersheds that were harvested in 2006. This monitoring and reporting program will also govern future THPs in these two watersheds. However, there can be no assurance that additional THPs in these two watersheds will in future years be enrolled or harvested as planned. The North Coast Water Board's adoption of these WWDRs has been appealed by third parties to the State Water Board, but the appeals are being held in abeyance pending implementation of the WWDRs. Because historic harvest patterns, adjacency restrictions, and the age classes of trees prevent the ready movement of harvesting activities between watersheds, development of WWDRs and the various other matters described above could result in reduced harvest levels in future years.

Effective January 1, 2004, California Senate Bill 810 provides regional water quality control boards, such as the North Coast Water Board, with additional authority related to the approval of THPs on timberlands within impaired watersheds. Palco and Scopac are uncertain of the operational and financial effects that ultimately will result from Senate Bill 810; however, because substantially all rivers and water bodies on the Timberlands are classified as sediment-impaired, implementation of this law could result in additional delays in obtaining approvals of THPs, lower harvest levels, and increased costs and additional protection measures beyond those contained in the HCP.

### **1.3. Overview of the Headwaters Agreement.**

Certain aspects of the Debtors' current compliance with applicable environmental and other land-use restrictions can best be understood in the context of a 1999 transaction carried out pursuant to the Headwaters Agreement between certain Debtors and the State of California and

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the United States involving approximately 5,600 acres of old-growth redwood forest. In September the United States and the State of California entered into the Headwaters Agreement with certain of the Debtors and MAXXAM. The Headwaters Agreement, among other things, provided for:

- the companies agreed to transfer to the United States and/or the State of California approximately 5,600 acres of the largest remaining old-growth redwood forest in private hands (the "Headwaters Forest ");
- the companies to receive from the United States and the State of California property and other consideration (possibly including cash) having an aggregate fair market value of \$300 million and 7,755 acres of adjacent timberlands to be acquired by the United States and California from a third party;
- expedited development, submission and approval by each of the parties, as applicable, of the HCP and SYP;
- the companies to dismiss their takings claims against the state and federal governments; and
- the companies, the United States, and the State of California to cooperate and act in good faith to preserve and defend any challenge to the Headwaters Agreement and the permits and agreements implementing it.

Thereafter, the federal and state governments appropriated the funds for purchasing the old-growth forest, and processed and approved the permits contemplated by the Headwaters Agreement, including the HCP, federal and state ITPs, a streambed-alteration agreement, and the SYP. Extensive discussion, deliberation, and negotiation took place among the parties throughout the process.

The Headwaters Agreement resulted in California's enabling and appropriation legislation, entitled Assembly Bill 1986. Assembly Bill 1986 includes certain specific additional limitations on land use that the legislature required to be incorporated in the final plan and permit documents. The bill also authorized the purchase of an MMCA known as the Grizzly Creek Complex and an MMCA known as Owl Creek. The State of California did in fact complete the purchase of these MMCAs, which are now held as public preserves and no longer constitute part of the timberlands of the Debtors.

### **1.4. Organizational Structure.**

Palco is a wholly owned subsidiary of MGI, which is wholly owned by MGHI, which is wholly owned by MAXXAM, a publicly traded company. Palco's business is described in Section [1.4] above.

Scopac, the largest wholly owned subsidiary of Palco, was organized as a special-purpose entity in May 1998 to facilitate the sale of the Pre-petition Timber Notes. Scopac's business is



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described above. Palco's other wholly owned subsidiaries are Britt, Scotia Development, Scotia Inn, and Salmon Creek, all of which are Debtors in these Reorganization Cases.

Like Palco, Britt produces and sells lumber products. See Section [1.2(d)(3)] above for a description of Britt's operations, including certain modifications that are in the process of being implemented. Salmon Creek was formed as a Delaware corporation in 1993, and in anticipation of the Headwaters Agreement Palco transferred certain timberlands to it. As a result, Salmon Creek, along with Palco and Scopac, was a party to the Headwaters Agreement (see Section [1.3]). Salmon Creek was converted to a Delaware limited liability company in 1999. Most of Salmon Creek's acreage was transferred under the Headwaters Agreement. Because the approximately 1,300 acres it continues to own are subject to Scopac Timber Rights, Salmon Creek has very limited operations.

Scotia Development was formed by MAXXAM in 2006 purportedly for the purpose of exploring and facilitating development opportunities with respect to commercial, industrial, and residential properties, including raw land, in California and Texas, as well as to assist Palco with the sale of certain assets. Scotia Development purportedly owns option rights to real property on the Texas Gulf Coast. Scotia Development was formed in violation of certain credit agreements, including the Palco Revolving Credit Agreement and the Palco Term Loan Agreement.

Scotia Inn operates a historic inn in Scotia, California in close proximity to Palco's headquarters building. The inn has previously been operated by third parties, but was acquired by Scotia Inn following its closure. The inn reopened in 2007.

### **1.5. Pre-petition Debt Structure.**

Before the Petition Date, the Debtors were dependent on borrowings under their revolving credit facilities, collection of receivables generated from operations, and access to customary trade credit to finance seasonal working capital requirements and to supplement operating cash flow.

#### **(a) Palco's Long-Term and Revolving Credit Debt.**

On the Petition Date, Palco's indebtedness consisted of a five-year \$85 million secured term loan and a five-year \$60 million secured asset-based revolving credit facility. These facilities were secured by security interests in substantially all of the assets of the Palco Debtors (other than Palco's Equity Interest in Scopac) and the stock of Palco held by MGI.

#### **(1) Palco Revolving Credit Facility.**

Palco and Britt's indebtedness under the Palco Revolving Credit Facility was governed by the Palco Revolving Credit Agreement. The amount available for borrowings under the Palco Revolving Credit Facility was normally the sum of 85% of the borrowers' eligible accounts receivable plus the lesser of (i) 80% of the book value of borrowers' eligible inventory or (ii) 85% of the net orderly liquidation value of such inventory. However, during each period from October 15 through January 15, the amount available for borrowing under the Palco Revolving

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Credit Facility was the sum of 95% of the borrowers' eligible accounts receivable plus the lesser of (i) 90% of the book value of Borrowers' eligible inventory or (ii) 95% of the net orderly liquidation value of such inventory. The amount available under the Palco Revolving Credit Facility could not exceed \$60 million. The Palco Revolving Credit Facility bore interest at rates of LIBOR plus 2.75% or prime plus 0.75%, at the borrowers' option; however, incremental borrowings made during each October 15 to January 15 utilizing the increased advance rates bore interest at the rate of LIBOR plus 4.50% or prime plus 2.50%, at the borrowers' option.

Prior to commencement of the Reorganization Cases, the Palco Revolving Credit Agreement required the borrowers to comply on a quarterly basis with certain financial covenants, including, among other terms, a minimum level of earnings and a minimum fixed-charge coverage ratio and maximum leverage ratio. As of the Petition Date, Palco and Britt believed that they were in default of certain financial covenants under the Palco Revolving Credit Agreement and the Palco Term Loan Agreement.

As of the Petition Date, approximately \$40 million (including \$14 million in letters of credit) was outstanding under the Palco Revolving Credit Agreement, for which Marathon was the administrative agent for the lending group. LaSalle Business Credit LLC was also a member of the lending group as of the Petition Date. During the course of the Reorganization Cases, Copartners Investments IV, LLC purchased the position previously held by LaSalle. When the DIP Facility was funded in August 2007 (as discussed more fully in Section [2.7]), it was used to repay the Palco Revolving Credit Facility.

### **(2) Palco Term Loan Agreement.**

Palco and Britt's indebtedness to Marathon under the Palco Term Loan is governed by the Palco Term Loan Agreement. The Palco Term Loan bears interest at the rate of LIBOR plus 8.75%. Borrowings under the Palco Term Loan are secured by a security interest in substantially all of the assets of the Debtors (other than Palco's Equity Interest in Scopac) and the stock of Palco held by MGI.

Before the Reorganization Cases began, the Palco Term Loan Agreement required that the borrowers repay a substantial portion of the outstanding principal of the Palco Term Loan with the net proceeds of various required asset sales, including the real property associated with Palco's former Fortuna and Carlotta mills. The agreement also required 270 Palco-owned homes in Scotia to be sold after certain prerequisites were met. The remaining principal balance of the Palco Term Loan was due on the maturity date, July 18, 2011. In addition, the Palco Term Loan Agreement required the borrowers to comply on a quarterly basis with financial covenants substantially identical to those under the Palco Revolving Credit Agreement.

As of the Petition Date, approximately \$84 million in borrowings were outstanding under the Palco Term Loan Agreement.

### **(b) Scopac Indebtedness.**

As of the Petition Date, Scopac's secured debt generally consisted of (i) the Pre-petition Timber Notes (\$713.8 million principal outstanding as of December 31, 2006) and (ii) the

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Scopac Loan, a line of credit with a group of banks pursuant to which Scopac was permitted to borrow to pay up to one-year's interest on the Pre-petition Timber Notes (\$36.2 million principal outstanding as of December 31, 2006). As of the Petition Date, annual interest obligations related to Scopac's debt facilities were approximately \$55.4 million. Scopac's obligations under the Pre-petition Timber Notes and the Scopac Loan are secured by a jointly held senior Lien on all of Scopac's assets including (i) the Scopac Timberlands, (ii) the Scopac Timber Rights, (iii) the geographical information system that contains information on numerous aspects of the Scopac Timberlands (subject to certain rights of concurrent use by Palco), (iv) the funds held in the SAR Account, (v) certain contract and other assets, and (vi) the proceeds of the foregoing.

Scopac is the sole obligor on both the Pre-petition Timber Notes and the obligations under the Scopac Loan. The Pre-petition Timber Notes and the Scopac Loan are not obligations of, and are not guaranteed by, Palco or any other Debtor.

**(1) Pre-petition Timber Notes.**

Scopac's senior secured indebtedness under the Pre-petition Timber Notes is governed by the Pre-petition Indenture. The Pre-petition Timber Notes are secured debt securities bearing interest at a rate of 6.55% for the A-1 Timber Notes, 7.11 % for the A-2 Timber Notes and 7.71 % for the A-3 Timber Notes. As of the Petition Date, approximately \$713.8 million in principal was outstanding on the Pre-petition Timber Notes, including: (i) \$7.4 million of A-1 Timber Notes; (ii) \$243.2 million of A-2 Timber Notes; and (iii) \$463.3 million of A-3 Timber Notes.

The Pre-petition Indenture contains various covenants that, among other things, limited the ability of Scopac to incur additional indebtedness, encumber assets, make certain asset dispositions, engage in transactions with affiliates, pay dividends, or make investments.

The Pre-petition Timber Notes were structured to link, to the extent of cash available, the deemed depletion of Scopac Timber (through the harvest and sale of logs) to the required amortization of the Pre-petition Timber Notes. The required amount of amortization on any Pre-petition Timber Note payment date was determined by various mathematical formulas set forth in the Pre-petition Indenture. The amount of principal Scopac was required to pay (on a cumulative basis and subject to available cash) through any payment date on the Pre-petition Timber Notes is referred to as Minimum Principal Amortization. If the Pre-petition Timber Notes had been amortized in accordance with Minimum Principal Amortization, the final installment of principal would have been paid on January 20, 2010, July 20, 2017 and July 20, 2028 for the A-1 Timber Notes, A-2 Timber Notes and A-3 Timber Notes, respectively. Scheduled Amortization is the amount of principal which Scopac was required to pay (on a cumulative basis) through any payment date on the Pre-petition Timber Notes in order to avoid prepayment or deficiency premiums. If all payments of principal had been made in accordance with Scheduled Amortization, Scopac would have paid the final installment of principal on January 20, 2014. This final installment would have been a single bullet principal payment of \$463.3 million in respect of the A-3 Timber Notes.

As of the Petition Date, Scopac had remained current under the Pre-petition Indenture, making all payments on the Pre-petition Timber Notes when due. However, prior to the January

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20, 2007, interest payment date, Scopac had insufficient liquidity to make the interest payment, which would have constituted an event of default under the Pre-petition Indenture.

### **(2) SAR Account.**

In November 1999, Palco contributed \$169.0 million from the sale of the Headwaters Timberlands to Scopac, which Scopac set aside in the SAR Account. Amounts in the SAR Account are part of the Collateral securing the Pre-petition Timber Notes and were used to make principal payments to the extent that cash flows from operations were insufficient to pay principal payments on the Pre-petition Timber Notes in accordance with Scheduled Amortization. In addition, on or after January 20, 2014, any amounts then remaining in the SAR Account were to be used to amortize the A-3 Timber Notes. As of the Petition Date, the SAR Account held approximately \$42.4 million in Cash and \$2.8 million of A-1 Timber Notes. Certain professional expenses incurred by the Indenture Trustee in these Reorganization Cases are paid from the SAR Account.

### **(3) The Scopac Loan.**

Borrowings under the Scopac Loan bore interest at the base rate plus 0.25% or at LIBOR plus 1.0% (the latter rate applying at any time that borrowings had not been continually outstanding for more than six months). The Scopac Loan was available to make interest payments on the Pre-petition Timber Notes, with the maximum borrowings being equal to one year's interest on the aggregate outstanding principal balance of the Pre-petition Timber Notes.

Bank of America National Trust is the agent for the Scopac Loan. As of the Petition Date, approximately \$36.2 million was outstanding under the Scopac Loan.

## **1.6. Financial Support of the Debtors by MGI.**

During 2005, MGI loaned a total of \$6 million to Palco on an unsecured and subordinated basis in order to support Palco's operations. During 2006, MGI loaned an additional \$30.9 million to Palco on the same basis, also to support its operations. These loans remain outstanding but are subordinated to amounts owed in respect of the Palco Term Loan and the Palco DIP Loan.

During 2006, MGI and Scopac also consummated the Lump Sum Purchases, three "lump-sum timber/log purchases pursuant to which MGI (rather than Palco) purchased timber and logs from Scopac, in certain instances earlier than Palco would have been required to purchase them from Scopac. Such purchases provided Scopac with a total of \$8.1 million of additional liquidity, which was used to support Scopac's operations and to pay interest to the Holders of Pre-petition Timber Notes. MGI later resold to Palco the timber and logs purchased from Scopac pursuant to the Lump Sum Purchases. The MGI sales to Palco were at the then-current market price, resulting in a loss to MGI. As a result, MGI bore 100% of the capital costs and price risk required to fund the Lump Sum Purchases, and MGI's purchases from Scopac effectively functioned as interest-free loans from MGI to Palco and Scopac. These amounts are also subordinated to amounts owed in respect of the Palco Term Loan and the Palco DIP Loan.

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MAXXAM alleges that it has historically furnished, at cost, important general and administrative assistance and other services to the Debtors (as well as its other subsidiaries), including risk-management services, accounting services, income tax reporting and compliance services, treasury and cash-management services, legal services, and employee-benefit services. As of the Petition Date, a significant amount of the allocable cost of these services allegedly provided had not been paid for by the Debtors, including: \$759,026 worth allegedly provided to Palco, \$23,331 worth allegedly provided to Britt, \$807,165 worth allegedly provided to Scopac and \$193,020 worth allegedly provided to Scotia Development for corporate services provided prior to the Petition Date, which has not been paid. MAXXAM has purportedly continued to furnish important general and administrative services that Maxxam claims are worth approximately \$1.2 million to the Debtors post-petition for which it will not seek reimbursement. In addition, all of these amounts are subordinated to amounts owed in respect of the Palco Term Loan and the Palco DIP Loan, and, with respect to Scopac, amounts owed in respect of the Scopac Loan and the Timber Notes.

### **1.7. Factors Leading to the Need for Bankruptcy Relief.**

The Debtors' need to reorganize their businesses under chapter 11 of the Bankruptcy Code was precipitated in part by the liquidity shortfalls at Palco and Scopac and their resultant inability to make January 2007 interest payments on their respective debt obligations. As noted above, Other factors that have contributed to the Debtors' deterioration include inefficient operations, poor customer service, competition from other products, a decline in housing construction and hostility and litigation with regulators, the local community and non-governmental environmental organizations.

The Debtors contend that their bankruptcies are solely the result of the debt they incurred and their inability to harvest at a level necessary to service that debt due to a "snarl of litigation" with regulators and the environmental community. However, the Plan Proponents believe the Debtors' problems are larger, and include a need for a new capital structure, a new long term strategic objective, a different approach with regulators and the community and a change in management to address issues with respect to the Debtors' operations. Accordingly, the Plan Proponents submit that the optimal plan of reorganization for the Debtors must address each of the preceding issues.

## **SECTION 2. EVENTS DURING THE REORGANIZATION CASES**

### **2.1. Commencement of the Reorganization Cases.**

On January 18, 2007, each of the Debtors filed a separate voluntary petition under chapter 11 of the Bankruptcy Code with the Bankruptcy Court. The Reorganization Cases are being jointly administered as *In re Scotia Development LLC, et al.*, Case No. 07-20027. The Debtors continue to manage and operate their respective businesses and properties as debtors in possession pursuant to sections 1107 and 1108 of the Bankruptcy Code. No trustee has been appointed in the case of any Debtor.

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**2.2. Schedules and Statements of Financial Affairs.**

The Debtors have filed their schedules and statements of financial affairs required under section 521 of the Bankruptcy Code and Bankruptcy Rule 1007. Copies of the Debtors' Schedules may be viewed online any time through the Bankruptcy Court's PACER System at [www.txsb.uscourts.gov](http://www.txsb.uscourts.gov) or at the Debtors' Claims Agent's website, [www.loganandco.com](http://www.loganandco.com).

**2.3. Retention of Professionals by the Debtors.**

The Debtors have obtained Bankruptcy Court approval to retain the following professional persons to represent the Debtors in their Reorganization Cases. Information for these professionals can be obtained from the Debtors' restructuring website, Debtors' restructuring-information website: [www.plchgpterrll.com](http://www.plchgpterrll.com).

**2.4. Official Committee of Unsecured Creditors.**

On January 25, 2007, the U.S. Trustee appointed an official committee of unsecured creditors for the Debtors. The Committee includes the following members:

Environmental Protection information Center, Interim Chairman c/o Sharon E. Duggan 370 Grand Avenue Suite 5 Oakland, CA 946210	Steve Wills Trucking & Logging, LLC c/o Steve Wills P.O. Box 335 Fortuna, CA 95540
Pacific Coast Trading, Inc. c/o Miles T. Crail 1690 Green Ash Road Reno, NV 89511	Steve Cave 2332 Wrigley Road Eureka, CA 95503
United Steelworkers c/o David Jury Five Gateway Center, Suite 807 Pittsburgh, PA 15222	Pension Benefit Guaranty Corp. c/o Adi Berger 1200 K Street, NW Washington, DC 20005
SHN Consulting Engineers & Geologists c/o Kenneth "Jeff Nelson 812 W. Walbash Eureka, CA 95501	

The Committee has retained professionals to represent the Committee. Information on the Committee's professionals can be obtained at [www.txsb.uscourts.gov](http://www.txsb.uscourts.gov) or at the Debtors'

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Claims Agent's website, [www.loganandco.com](http://www.loganandco.com), or at the Debtors' restructuring information website, [www.plchgpterrll.com](http://www.plchgpterrll.com).

### **2.5. Secured Lenders.**

Pursuant to the various loan and credit agreements described herein, the Debtors are liable for the fees and expenses of the professionals retained by secured lenders. These fees are not subject to supervision of the Bankruptcy Court or the fee procedures described above and are paid in full by the Debtors in the ordinary course of business. Information on the secured lenders' professionals can be obtained at [www.txsb.uscourts.gov](http://www.txsb.uscourts.gov) or at the Debtors' Claims Agent's website, [www.loganandco.com](http://www.loganandco.com), or at the Debtors' restructuring information website, [www.plchgpterrll.com](http://www.plchgpterrll.com).

### **2.6. Use of Cash Collateral.**

The Debtors' businesses require the use of working capital to fund payroll and payroll taxes, to pay normal operating expenses, and to pay other business expenses. Certain creditors possess interests in the Palco Debtors' cash collateral pursuant to various pre-petition agreements. Under the Palco Revolving Credit Facility and the Palco Term Loan, Marathon and Canpartners Investments IV, LLC-as assignee of LaSalle Bank National Association and LaSalle Business Credit, LLC possessed security interests in cash collateral held by Palco, Scotia Development, Britt, Salmon Creek, and Scotia Inn. Through a series of stipulated orders approved by the Bankruptcy Court, the Palco Debtors were authorized to use cash collateral to fund their operating expenses from the Petition Date through the closing of the DIP Facility in August 2007.

Similarly, Scopac's use of cash collateral was subject to claims by Bank of America National Trust and Savings Association and The Bank of New York Trust Company, NA, as the Pre-petition Indenture Trustee. Scopac's continued use of cash collateral is limited by budgets setting forth Scopac's projected receipts and disbursements and by terms specified in such orders approving the use of cash collateral. Pursuant to stipulations between Scopac, Bank of America, and the Pre-petition Indenture Trustee, Scopac pays limited portions of the monthly expenses of the legal and other professionals retained by its secured creditors.

### **2.7. Approval of Debtor-in-Possession Financing.**

The Palco Debtors' projections indicated that their cash flow would not be not adequate to continue their ongoing business operations during the Reorganization Cases. Consequently, the Palco Debtors required not only the use of cash collateral but also borrowings under the DIP Facility in order: (a) to pay rent, taxes, utilities, salaries, wages, and employee benefits, (b) to purchase inventory and supplies, (c) to make certain required capital expenditures, and (d) to continue the operation of their businesses without interruption. To meet their working capital needs during the pendency of the Reorganization Cases, the Palco Debtors negotiated the DIP Facility with Marathon. The Palco Debtors and their financial advisors considered other entities as potential providers of debtor-in-possession financing, but ultimately decided to proceed with Marathon, one of Palco's pre-petition lenders, in light of the expense and risk of a contentious debtor-in-possession priming transaction with other potential lenders and the additional cost of a

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debtor-in-possession financing transaction with other potential lenders (including higher interest rates and fees).

The DIP Facility provides for a \$75,000,000 revolving line of credit, reduced by certain reserves. This amount includes a sub-limit of \$5,000,000 for letters of credit which could be issued by a separate issuing bank, with certain lenders guaranteeing the related reimbursement obligations.

Proceeds from the DIP Facility must be used: (a) to repay in full all obligations under the Palco Revolving Credit Facility, including accrued and unpaid interest, expenses and fees thereon (including applicable default interest payable from and after the Petition Date), (b) to cash-collateralize all outstanding letters of credit under the Palco Revolving Credit Facility in accordance with its terms, (c) to pay certain fees, costs and expenses relating to the debtor-in-possession financing, (d) to finance working capital needs of the Palco Debtors and for other general corporate purposes, in accordance with budgets to be submitted weekly, or (e) to fund collateralization of letters of credit or other credit support provided by other financial institutions.

Loans extended under the DIP Facility constitute super priority Administrative Expense Claims under section 364(c)(1) of the Bankruptcy Code having priority over all other obligations, liabilities, and indebtedness of the Palco Debtors. DIP Facility Loans are secured by perfected and first priority liens, mortgages, and security interests in respect of substantially all of Palco Debtors' property. The DIP Facility also contains representations and warranties, covenants, and indemnity provisions that are customary for credit facilities of this type.

The DIP Facility was approved by the Bankruptcy Court on July 31, 2007, and was funded on August 6, 2007.

**2.8. Motion to Transfer Venue of Debtors' Reorganization Cases.**

In February 2007, the U.S. Trustee, the Committee, certain noteholders, and certain agencies and governmental entities for the State of California (collectively the "Movants") filed motions seeking to transfer the Reorganization Cases from the Southern District of Texas, Corpus Christi Division to the Northern District of California, Oakland Division. LaSalle Business Credit LLC opposed a transfer of venue to California but sought an intra-district transfer to the Houston Division. The Bankruptcy Court denied the requests to transfer venue. None of the Movants appealed the Bankruptcy Court's order.

**2.9. Motion to Designate  
Scopac's Reorganization Case as a  
Single Asset Real Estate Case.**

On February 5, 2007, certain of Scopac's Creditors filed a motion for determination that Scopac is a single-asset real estate debtor and for an order requiring Scopac to comply with section 362(d)(3)(A) of the Bankruptcy Code. The Bankruptcy Court heard the motion and, on April 5, 2007, issued a final order finding that Scopac is not a "single asset real estate debtor



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under the Bankruptcy Code. The Fifth Circuit Court of Appeals affirmed the Bankruptcy Court's decision by order dated November 13, 2007.

### **2.10. Payment of Pre-petition Obligations to Certain Critical Vendors.**

Through two separate requests, the Debtors sought and obtained authority from the Bankruptcy Court to pay pre-petition amounts owed to certain critical vendors, conditioned upon their extending credit and supplying materials, equipment, goods, and services to the Debtors in accordance with pre-petition practices. The Debtors determined that the continued supply of goods and services from the critical vendors was necessary to avoid severe, and possibly fatal, disruptions to the Debtors' business. The Debtors' critical vendors consist of loggers, haulers and other providers of specialized goods and services in their forest-products operations.

The Bankruptcy Court authorized Scopac to pay its critical vendors an aggregate amount of \$198,000. The Bankruptcy Court similarly authorized the Palco Debtors to pay their critical vendors that are loggers and haulers an aggregate amount not to exceed \$575,000, absent written consent from its secured lenders and only after providing the Committee with an opportunity to object to such additional payments.

### **2.11. Bar Dates.**

On May 16, 2007, the Bankruptcy Court signed the Bar Date Order setting July 17, 2007 as the general Bar Date and August 17, 2007 as the Bar Date applicable to all Governmental Units. Pursuant to the Bar Date Order, any Person or Entity holding a Claim that arises from the rejection of an executory contract or unexpired lease where the order authorizing such rejection is dated after June 15, 2007, is required to file a Proof of Claim on the later of the Bar Date or thirty days after the effective date of such order authorizing the rejection or forever be barred from doing so. Because the Plan provides that all executory contracts or unexpired leases not specifically assumed by the Debtors pursuant to section 365(a) of the Bankruptcy Code (see Article 7.1. of the Plan) are rejected as of the Effective Date of the Plan, the Plan modifies the Bar Date for Claims arising out of the rejection of such executory contracts or unexpired leases (see Section [5.4] below).

Additionally, a person or entity (i) whose Claim is listed on the Debtors' Schedules, (ii) whose Claim is not described as "disputed," "contingent," or "unliquidated," and (iii) who does not dispute the amount and manner of classification of the Claim as set forth in the Schedules, is exempted from filing a Proof of Claim. Similarly, a Debtor holding a Claim against one or more of the other Debtors, is exempted from filing a Proof of Claim.

The Bankruptcy Court signed the Supplemental Bar Date Order on July 13, 2007, setting a supplemental Bar Date for creditors of whose identity or claim the Debtors were unaware, and approving the form and manner of broad publication notice intended to reach such creditors. The Supplemental Bar Date Order set September 5, 2007, as the deadline for unknown creditors to file proofs of claim and authorized the Debtors to publish notice of such supplemental Bar Date in certain local newspapers and periodicals.

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Pursuant to the Bar Date Order and Supplemental Bar Date Order, Claimants were required to file their Proofs of Claim on or before the applicable Bar Date. Any Claimant who did not file a Proof of Claim by the applicable Bar Date (except as specifically otherwise provided): (a) will not be treated as a Creditor of the Debtors for purposes of notice, voting and distribution under the Plan; and (b) will be forever barred from filing a Proof of Claim with respect to such Claim and asserting such Claims against the Debtors, their Estates, or property.

### **2.12. Resolution of Objections to Disputed Claims**

Upon information and belief, the Debtors have begun reviewing all Proofs of Claim filed in their Reorganization Cases, and anticipate presenting objections to many of those Proofs of Claim prior to the Confirmation Hearing. Although the Debtors expect there to be substantial progress in resolving objections to Proofs of Claim prior to the Confirmation Hearing, it is likely that the Proof of Claim objection process will continue beyond the Confirmation Hearing.

If you filed one or more Proof(s) of Claim in one or more of the Debtors' Reorganization Cases, and the Debtors have not objected to such Proof(s) of Claim on or before the Record Date, you will receive a ballot and be entitled to vote to accept or reject the Plan. If, however, the Debtors have objected to your Proof(s) of Claim on or before the Record Date, then you will not receive a ballot and you will not be entitled to vote to accept or reject the Plan absent an order by the Bankruptcy Court temporarily allowing such Proof(s) of Claim pursuant to Bankruptcy Rule 3018. You should obtain legal counsel of your choice to ascertain your rights in those circumstances.

### **2.13. Employee Matters.**

#### **(a) Payment of Pre-petition Wages and Benefits.**

In order to ensure the continued and uninterrupted service of their employees, soon after the Petition Date and on an emergency basis, the Debtors sought authority to pay or honor accrued and unpaid pre-petition compensation, benefits and other employee obligations.

Palco, Scotia Inn, and Britt obtained Bankruptcy Court approval (i) to pay pre-petition employee bonus and wage claims not exceeding \$10,000 per employee, (ii) to honor workers' compensation obligations as they came due in the regular course of business, and (iii) to make certain funding contributions to Palco's defined benefit pension plan. Similarly, Scopac was granted authority (i) to pay accrued but unpaid pre-petition wages, salaries and incentive compensation, (ii) to continue those payments in the ordinary course of business on a post-petition basis, (iii) to pay outstanding pre-petition benefit plan contributions within the limits set forth under section 507(a)(5) of the Bankruptcy Code, and (iv) to continue to offer and pay existing employee benefits on a post-petition basis.

Prior to the filing of the Reorganization Cases, the Debtors took steps to reduce their work force in response to their increasing financial difficulties. On December 1, 2006, the Debtors instituted a severance program (a reduction in force, or RIF) in an effort to comply with the Worker Adjustment and Retraining Notification Act. Under this severance program, the Debtors promised each terminated employee 60 days' wages and, for employees with more than

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five years of service, severance payments tied to the length of their service with the Debtors. The severance payments were to be made 60 days after termination; however, the Debtors filed their chapter 11 bankruptcy petitions before the payments were made. On May 17, 2007, the Debtors a motion pursuant to which Scopac sought to pay \$102,996, and the Palco Debtors sought to pay \$843,890, to terminated employees in accordance with the severance program. On September 21, 2007, the Bankruptcy Court denied the Debtors' motion.

**(b) Payment of Quarterly Pension Obligations.**

Prior to the Petition Date, Palco offered its employees a tax-qualified defined benefit pension plan that provides a certain amount of monthly income upon the employee's retirement, at no cost to the employee. The pension plan was frozen as of the December 31, 2005, meaning that while vested benefits are not affected, there is no accrual of any additional or new benefits. Although no new benefits are accrued, Palco continues to have funding requirements.

As of the Petition Date, Palco's total estimated amount of pre-petition liability for contributions and fees with respect to its employees under the pension plan was approximately \$20.6 million. Prior to the Petition Date, Palco made quarterly payments in respect of its funding obligations under pension plan, and upon filing its Reorganization Case, Palco sought Bankruptcy Court approval to continue making such quarterly payments. By orders dated April 13, 2007, July 13, 2007, September 18, 2007, and October 5, 2007 the Bankruptcy Court approved one-time payments of \$588,625, \$588,625, \$552,910, and \$783,625 respectively. Palco intends to seek Bankruptcy Court approval for additional quarterly payments as they become due.

**(c) Approval of Employee Incentive and Retention Plans.**

In order to help retain and incentivize the Debtors' workforce, Palco, Britt, and Scopac filed motions seeking approval of certain retention and incentive plans applicable to non-officer employees.

First, the mill employee incentive plan, which targets production-level employees working in Palco's and Britt's lumber and fencing operations and the power plant, provides for a cash bonus of up to nine percent of the employee's base pay. This bonus is conditioned upon the achievement of specified performance levels in safety, financial and production.

Second, the non-officer retention plans, which respectively target employees working in Palco's and Britt's administrative departments and key employees of Scopac (including scientists and members of Scopac's forestry program), provide for a Cash award of up to four months' additional base pay for employees.

Payment under these plans is not due until and unless a Confirmation Order is entered and awards are only payable to employees who remain employed continuously on a full time basis through the Confirmation Date. The Bankruptcy Court approved the Debtors' retention and incentive plans on August 24, 2007.

**(d) Motions Regarding Employment Agreement with Gary C. Clark.**

Mr. Clark has been a Vice-President and the chief financial officer of Palco, Britt and Scopac since 1993 and Scotia Inn since 2005. On July 25, 2007, Palco filed a motion with the Bankruptcy Court seeking authority to assume Mr. Clark's employment agreement. The Committee and U.S. Trustee objected to Palco's motion on the ground that the employment agreement included payments that are prohibited under BAPCPA. In response to these objections, Palco filed a supplemental motion on August 25, 2007, seeking to reject the pre-petition employment agreement and enter into a new employment agreement with Mr. Clark. If approved, the new employment agreement would extend Mr. Clark's employment with the Debtors through April 30, 2008. The agreement also would substantially increase Mr. Clark's monthly salary, partially in exchange for Mr. Clark's agreement to waive certain Claims against the Debtors and further postpone his retirement. The Bankruptcy Court has taken Palco's supplemental motion under advisement.

**2.14. Exclusivity.**

Section 1121(b) of the Bankruptcy Code establishes an initial period of 120 days after a bankruptcy court enters an order for relief under chapter 11 of the Bankruptcy Code during which only the debtor may file a plan. By order of the Court on December 21, 2007, the Bankruptcy Court terminated exclusivity.

**2.15. Mediation.**

Following the October 23 hearing, regarding the Debtors' motion to extend exclusivity, the Bankruptcy Court ordered the Debtors, MAXXAM, and major creditor constituencies (which included the Pre-petition Indenture Trustee, the Committee, Marathon, Bank of America, and various California state agencies) to participate in mediation. By order dated November 16, 2007, Chief Judge for the Fifth Circuit Court of Appeals assigned Judge Barbara J. Houser (Chief Bankruptcy Judge for the Northern District of Texas), as the mediator. The parties participated in meetings with Judge Houser. A final mediation session was held on December 12, 2007. Although the parties exchanged ideas and were hopeful that a global settlement could be reached, the parties reached an impasse.

**2.16. Extension of Time to Assume, Assume and Assign, or  
Reject Unexpired Leases of Nonresidential Real Property.**

By order dated August 14, 2007, the Bankruptcy Court extended the time by which the Debtors must determine whether to assume or reject certain unexpired leases of nonresidential real property until entry of an order confirming a plan of reorganization with respect to the Debtors' Reorganization Cases. The extension applies to the leases identified in the chart below:

<b><u>Lessee</u></b>	<b><u>Landlord</u></b>	<b><u>Lease Description</u></b>
Palco	Jeannie Mantova and Jeannie Mantova	Substation Use Agreement: A "Use Agreement dated January 16, 1996 pertaining to an energy substation in Humboldt County, California

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Britt	Steve Sellers	Mad River Industrial Complex: A lease of commercial real property in Arcata, California, used for lumber remanufacturing and storage purposes
Britt	Humboldt Plywood Corporation	Christie Sublease: A lease of a sawmill and manufacturing plant in Humboldt County, California
Palco	Scopac	Master Lease Agreement: A master lease under which Scopac leases various parcels of land to Palco
Scopac	Palco	Scopac Office Lease: A lease of several commercial premises located in Scotia, California

### 2.17. Asset Sales.

#### (a) Completed Real Property Sales.

By order dated February 16, 2007, Palco obtained Bankruptcy Court approval authorizing it to sell 39.37 acres of real property located southeast of Fortuna, California to River View Terrace, LLP for a total purchase price of \$1,250,000.

#### (b) De Minimis Sales of Personal Property.

By motion dated September 25, 2007, the Debtors have sought authority to sell *de minimis* personal property without the need for Bankruptcy Court approval upon five Business Days' notice to the U.S. Trustee, counsel for the Committee, and counsel for Marathon. The Debtors intend to use this procedure to sell *de minimis* personal property and avoid the related court costs of filing separate motions for each proposed sale. By order dated October 4, 2007 the Bankruptcy Court approved the Debtors' motion.

### 2.18. Reduction in Force and Production Changes.

On or about August 1, 2007, Palco announced several changes with respect to its operations. In light of the challenges facing the industry as whole, including depressed housing construction trends and reduced demand for lumber products, Palco shut down its Scotia, California sawmill on August 3, 2007, for one month in order to conserve its financial resources. Palco resumed operations in its Scotia mill on September 4, 2007. As part of its new operational strategy, Palco eliminated its second shift at the Scotia mill (which was approximately 75% Douglas-fir and 25% redwood), and implemented a one-shift strategy that focuses entirely on redwood. This change in strategy also precipitated a reduction in force. The reduction in force covers approximately 100 employees in the aggregate, including those at the Scotia mill and Britt mill. The Britt mill was idled, and those employees have received WARN act notices. The employees at the Scotia mill are not subject to the WARN act given the size of the reduction in force.

**2.19. Authority to Finance Insurance Premiums.**

By order of the Bankruptcy Court dated July 19, 2007, Palco obtained authority to finance on a secured basis \$1.1 million needed for the payment of certain property insurance premiums. The financing was provided by AICOO, Inc. Palco has financed subsequent insurance premiums consistent with the procedures set forth in the July 19th order.

**2.20. Additional Information.**

Additional information and copies of key documents and notices can be obtained at [www.txsb.uscourts.gov](http://www.txsb.uscourts.gov) or at the Debtors' Claims Agent's website, [www.loganandco.com](http://www.loganandco.com), or at the Debtors' restructuring information website, [www.plchgpterrll.com](http://www.plchgpterrll.com).

**SECTION 3.  
LITIGATION**

**3.1. Claims Against the Debtors.**

While the below-described legal proceedings are, in general, stayed as against the Debtors while the companies are in bankruptcy, such proceedings could be pursued as against the Debtors if the stay is modified by the Bankruptcy Court, if the Reorganization Cases are dismissed, or in certain circumstances, upon the emergence of the Debtors from bankruptcy.

**(a) The EPIC-SYP/Permits and USWA Lawsuits.**

In March 1999, an action entitled *Environmental Protection Information Association, Sierra Club v. California Department of Forestry and Fire Protection, California Department of Fish and Game, The Pacific Lumber Company, Scotia Pacific Company LLC, Salmon Creek Corporation, et al.* was filed in Superior Court in Humboldt County, California (No. CV-990445). This action alleged, among other things, various violations of the California Endangered Species Act and the California Environmental Quality Act, and challenged, among other things, the validity and legality of the SYP and the California Permits and sought, among other things, to prevent implementation of THPs approved in reliance upon these documents. This action also alleged impropriety by the California Board of Forestry and Fire Protection in conducting Headwaters reviews and granting permits and approvals.

In March 1999, a similar action, entitled *United Steelworkers of America, AFL-CIO, CLC, and Donald Kegley v. California Department of Forestry and Fire Protection, The Pacific Lumber Company, Scotia Pacific Company LLC and Salmon Creek Corporation*, was filed in Humboldt County Superior Court (No. CV-990452) challenging the validity and legality of the SYP. The *EPIC-SYP/Permits* and *USWA* lawsuits were consolidated for trial.

Following the trial, the court in October 2003 entered a judgment invalidating the SYP and the California Permits and in September 2004 granted the plaintiffs' request for reimbursement of an aggregate of \$5.8 million in attorneys' fees and other expenses. The Debtors and various state agencies for the State of California appealed both decisions. In December 2005, the appellate court reversed the trial court's decision invalidating the SYP and

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the California Permits. The plaintiffs have appealed the appellate court's decision to the California Supreme Court, which has accepted the appeal for review. The defendants' appeal of the trial court's award of attorneys' fees and expenses is still pending at the appellate court. Due to the Reorganization Cases, both the California Supreme Court and the appellate court entered orders staying the proceedings pending before each court. However, at the request of the Debtors, the Bankruptcy Court modified the automatic stay by an order dated June 29, 2007 for the limited purpose of allowing the appeal to proceed.

### **(b) Bear Creek Lawsuit.**

In July 2001, an action entitled *Environmental Protection Information Association v. Pacific Lumber, Scotia Pacific Company LLC* (No. C01-2821) was filed in the U.S. District Court for the Northern District of California, and later amended to add the EPA as a defendant. The lawsuit alleges that harvesting and other forestry activities under certain of Scopac's THPs will result in discharges of pollutants in violation of the Federal Clean Water Act. The plaintiff asserts that the Federal Clean Water Act requires the defendants to obtain a National Pollution Discharge Elimination System permit from the North Coast Water Board before beginning timber harvesting and road construction activities and is seeking to enjoin these activities until such permit has been obtained. The plaintiff also seeks civil penalties of up to \$27,500 per day for the alleged continued violation of the Federal Clean Water Act. In October 2003, the court upheld the validity of an EPA regulation that exempts harvesting and other forestry activities from certain discharge requirements. Due to the Reorganization Cases, the court has entered an order staying this matter.

### **(c) Watershed Flooding Damages Lawsuits.**

On November 20, 2002, a lawsuit involving two similar actions entitled *Alan Coop et al. v. Gary Clark, et al* and lawsuit entitled *Steve Cave, et al. v. Gary Clary et al.* were filed in Humboldt County Superior Court (Nos. DR020718 and DR020719, respectively), which also name Palco and certain affiliates as defendants. The *Cook action* alleges, among other things, that defendants' logging practices have contributed to an increase in flooding along Freshwater Creek (which runs through the Timberlands), resulting in personal injury and damage to the plaintiffs' properties. Plaintiffs further allege that in order to have THPs approved in the affected areas, the defendants engaged in certain unfair business practices. The plaintiffs seek, among other things, compensatory and exemplary damages, injunctive relief, and appointment of a receiver to ensure that the watershed is restored. The *Cave action* contains similar allegations and requests similar relief with respect to the Elk River watershed a portion of which is contained on the Timberlands. The plaintiffs in the *Cave action* filed a statement of damages of \$3 to \$4 million in property damages and \$2 to \$3 million in special damages for emotional distress and punitive relief.

On October 13, 2005, an action entitled *Edyth Johnson, et. al v. Charles E. Hurwitz, an individual; MAXXAM Inc. et al.* (No. DR040720) was filed in Humboldt County Superior Court and contains allegations similar to the *Cave* and *Cook actions*.

**(d) Unfair Business Practices Lawsuit.**

On February 25, 2003, the District Attorney of Humboldt County filed a civil suit entitled *The People of the State of California v. The Pacific Lumber Company, Scotia Pacific Holding Company and Salmon Creek Corporation* in the Humboldt County Superior Court (No. DR030070). The suit was filed under California's unfair competition law and alleges that the Debtors used certain unfair business practices in connection with completion of the Headwaters Agreement, and that this resulted in the harvest of significantly more trees than would have otherwise been the case. The suit seeks a variety of remedies including a civil penalty of \$2,500 for each additional tree that has been or will be harvested due to this alleged increase in harvest, as well as restitution and an injunction in respect of the additional timber harvesting allegedly being conducted. On June 14, 2005, the trial court dismissed this matter in its entirety. On September 19, 2005, the District Attorney appealed this decision. Due to the Reorganization Cases, the appellate court initially entered an order staying the appeal. The Debtors and the District Attorney, however, desired to conclude the appeal. Therefore, at the request of the Debtors and the District Attorney, the Bankruptcy Court modified the automatic stay by order dated July 31, 2007 to allow the appeal to proceed.

**(e) Wrongful Termination.**

Palco is a defendant in an action entitled *Jimmy Dan Cook and Judy Cook v. Robert Manne, The Pacific Lumber Company and Does 1-50* (No. DR060121), which was filed in the Superior Court of Humboldt County, California on March 6, 2006. The lawsuit alleged wrongful termination and related claims for breach of contract and breach of the covenant of good faith and fair dealing based upon the alleged wrongful termination of a employee by Palco and its former President and Chief Executive Officer. The complaint alleges that Mr. Cook was wrongfully discharged because he resisted and questioned certain illegal acts relating to the construction of a sedimentation pond in Scotia, California during the summer of 2004. Ms. Cook dismissed her claim with prejudice on March 27, 2006, but Mr. Cook's claim is still pending. Both parties had filed motions for summary judgment, but on February 27, 2007, the court entered an order directing the clerk to administratively close the case pending the Reorganization Cases.

**(f) Qui Tam limitation.**

On December 7, 2006, the Qui Tam Relators initiated the two Qui Tam Actions against the Debtors, MAXXAM, and Charles E. Hurwitz, the Chairman of the Board and Chief Executive Officer of MAXXAM. A qui tam action is a lawsuit brought in the name of the government by a private individual called a "relator" against a company or person who the relator alleges has committed some significant violation of law in the performance of a contract with or in obtaining payment from the government. Any recovery is for the benefit of the government; however, the relator is allowed to seek a large percentage of any recovery as a "reward. Also, the government is entitled to intervene and take over the action if it wishes to pursue the action itself.

In the Qui Tam Actions the Qui Tam Relators allege that the defendants had obtained property from the United States and California by "fraud because the SYP approved by the CDF



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as an agency of the State of California nearly eight years earlier as part of the Headwaters Agreement allegedly relied on improper modeling and computer simulations. The Qui Tam Actions allege that, had the Debtors fully disclosed the manner in which the SYP had been prepared, the SYP would not have been approved by the CDF, and the United States and California would not have paid the amount of cash and other consideration for the Headwaters Timberlands they acquired. The Qui Tam Actions further allege that the consideration given in exchange for the Headwaters Timberlands and other timberlands exceeded the land's value because of existing regulatory restrictions under the Endangered Species Act. The Qui Tam Relators claim that the difference between the consideration paid and the actual value of the land transferred represents a "false claim improperly paid by the United States and by California and, therefore, all defendants, including the Debtors, are liable for treble damages totaling approximately \$1 billion.

As required by Federal and State law, the Qui Tam Relators filed the Qui Tam Actions under seal, and the United States and State of California then each had 60 days to review the relevant complaint and decide whether to take over the prosecution of the Qui Tam Actions. After review, both the United States and the State of California declined to pursue the Qui Tam Actions. The Qui Tam Actions were then unsealed and the Debtors then learned of the Qui Tam Actions only after they had filed the Reorganization Cases.

Upon the filing of the Reorganization Cases, the automatic stay prevented the further prosecution of the Qui Tam Actions as to the Debtors. However, the Qui Tam Actions proceeded as to non-debtor parties. Since the Debtors may be prejudiced by findings in any judgment entered against the non-debtor parties, on June 25, 2007 the Debtors filed an adversary action before the Bankruptcy Court to extend the automatic stay to non-debtor parties and enjoin the Qui Tam Relators from proceeding against MAXXAM and Hurwitz (*The Pacific Lumber Company, et. al. v. State of California ex rel. Richard Wilson and Chris Maranto, et. al.*, Adv No. 07-02038). On August 3, 2007, the Bankruptcy Court heard argument on the Debtors' motion for summary judgment and for injunctive relief. The Bankruptcy Court has not yet issued a decision on the Debtors' motions.

On July 17, 2007, the Qui Tam Relators filed the Qui Tam Claims the contents of which mirror the Qui Tam Actions. The Qui Tam Claims assert damages of over \$1 billion against three of the Debtors for an aggregate of over \$3 billion in claims. The Qui Tam Relators also allege that the damages asserted in the Qui Tam Claims are non-dischargeable pursuant to sections 1141(d)(6) and 523(a)(7) of the Bankruptcy Code.

On September 13, 2007, the Debtors filed an objection to the Qui Tam Claims in the Reorganization Cases under section 502(b) of the Bankruptcy Code and also filed an alternate motion to estimate the Qui Tam Claims for all purposes under section 502(c) of the Bankruptcy Code on the ground that liquidation of the claims will unduly delay the administration of the Reorganization Cases.

The Bankruptcy Court has set hearing dates of February 19-29, 2008, during which the Court will either conduct proceedings to liquidate the Qui Tam Claims or to estimate the Qui Tam Claims, to be determined by the Court prior to the occurrence of the hearing dates.

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On September 13, 2007, the Debtors also filed an adversary action against the Qui Tam Relators seeking a declaration that, notwithstanding section 1141(d)(6) of the Bankruptcy Code, the Qui Tam Claims (if they are allowed or estimated in any amount) are subject to discharge under the Bankruptcy Code because the Qui Tam Relators failed to timely file a complaint to determine dischargeability in accordance with section 523(c) of the Bankruptcy Code and Bankruptcy Rule 4007(c). (*The Pacific Lumber Company, et. al. v. State of California ex rel. Richard Wilson and Chris Maranto, et. al.*, Adv. No. 07-2081-C) (the "Dischargeability Action"). The Dischargeability Action is set for a final pre-trial conference on March 25, 2008.

### **3.2. Claims by the Debtors.**

#### **(a) Headwaters Breach of Contract Claim.**

In December 2005, Palco and Scopac filed a claim with the California Victim Compensation and Government Claims Board against the North Coast Water Board, the State Water Board and the State of California (Claim No. G558159). The claim alleges that the defendants have substantially impaired the contractual and legal rights of Palco and Scopac under the Headwaters Agreement and the related permits, authorizations and approvals. The Claims Board failed to approve or deny the claim by the statutory deadline. As a result, the claim is by operation of law treated as having been denied, and Palco became entitled to file a suit for damages in California state court. Palco and Scopac filed such a suit on December 20, 2006 in Superior Court in Fresno, California (No. CECG 0422).

#### **(b) Bad Faith Coverage-Denial Claim.**

On January 12, 2006, Palco and various of its affiliates filed an action entitled *The Pacific Lumber Company, Scotia Pacific Company LLC, MAXXAM Inc., MAXXAM Group Inc., MAXXAM Group Holdings Inc., Charles E. Hurwitz, Gary Clary John Campbell and Robert Manne vs. General Star Indemnity Company, and Transportation Insurance Company* in the United States District Court for the Northern District of California, San Francisco Division (No. 06-0212 (EDL)). Palco and its affiliates allege that their current and prior insurers used bad faith in denying coverage for the flooding damages in the Elk River and Freshwater creek, as described above in the Cave, Cook and Johnson actions. The three cases making up this action are complicated by the several policies involving a number of different insurers of various parties in varying risks at different points in time.

## **SECTION 4. THE REORGANIZATION OF NEWCO**

On or prior to the Effective Date, the Plan Proponents shall contribute \$225 million in Cash to Newco. Also on the Effective Date, the Debtors shall be reorganized into two newly formed Reorganized Entities, Newco and Townco, and, except as otherwise set forth herein, all of the Debtors' Assets shall be transferred to these Reorganized Entities free and clear of all Claims, Liens, charges, other encumbrances and Interests. On and after the Effective Date, the Reorganized Entities may operate their businesses, may use, acquire and dispose of property, may retain, compensate and pay any professionals or advisors, and compromise or settle any causes of action, claims or interests without supervision of or approval by the Bankruptcy Court

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and free and clear of any restrictions of the Bankruptcy Code or the Bankruptcy Rules other than restrictions expressly imposed by the Plan and the Confirmation Order.

Newco is the Reorganized Entity that will include the assets of the Mill and the Timberlands, together with any and all Assets of the Debtors currently associated with or anticipated to be associated with Mill and the Timberlands on and after the Effective Date.

Newco will be managed and run by MRC.

### **4.1. MRC's Background.**

MRC was formed on June 30, 1998 with capital supplied largely by the Fisher family from San Francisco, California. Doris and Don Fisher founded the Gap in 1969, and as a family continue to be significant shareholders in Gap Inc. The Fisher family has supported a number of environmental causes over time. In addition, Bob Fisher has served on the board of the Natural Resources Defense Council (NRDC) for more than 15 years and is currently the Vice Chairman of the board of NRDC. Bob Fisher has also served on the board of Conservation International (CI) for the last 8 years, and is currently the Chairman of the Executive Committee of CI.

MRC was created with 230,000 acres of timberlands previously owned by Louisiana Pacific ("LP") for a period of 25 years. Through related affiliates, MRC also bought 2 sawmills, a distribution business, and associated operations. LP managed the lands, now owned by MRC, with a traditional industrial approach. LP relied on significant clear cutting, harvesting in excess of the forest's growth rate. Accordingly, LP's relations with the community at the time of acquisition could be characterized by anger, mistrust and skepticism.

MRC started with a publicly declared purpose: "to demonstrate it is possible to manage productive forestlands with a high standard of environmental stewardship, and also operate a successful business." There are numerous examples of what it means to be a successful business; but, far fewer of good stewardship. In an effort to address stewardship objectives, MRC early on made specific forest policy changes.<sup>2</sup> MRC's new policies included:

- Eliminating traditional clear cutting,
- Implementing an old growth policy down to level of tree,
- Reducing the level of harvest,
- Pursuit and attainment of Forest Stewardship Council (FSC) certification.<sup>3</sup>

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<sup>2</sup> See [www.mrc.com](http://www.mrc.com) for significant additional information about the history, policies, and 10 year progress of MRC and its 230,000 acres of forestlands in Mendocino County.

<sup>3</sup> Forest Stewardship Council certification is an independent third party standard of exemplary forest management supported by leading environmental groups, such as World Wildlife Fund, Natural Resources Defense Council and Greenpeace. See [www.fscus.org/membership](http://www.fscus.org/membership) for a complete list of current NGO members of the Forest Stewardship Council in the United States.

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Now, almost ten years later, there is measurable ecological progress in MRC's forest. In particular:

- standing conifer (redwood and Douglas fir) timber inventory has increased by more than 25% (approximately 600 million board feet)
- 40,000 acres, once rich in redwood and Douglas fir (conifers), that had become overgrown with tan oak as a result of legacy forest practices dating as far back as the 1850's, have been treated so that a robust conifer forest will again emerge in the next 30 to 40 years.
- Investment of \$11 million in sediment and erosion control that has withheld almost 700,000 cubic yards of sediment (the equivalent of almost 70,000 dump trucks) from fouling streams and rivers running through the MRC forest.

MRC has purposefully operated in an open and transparent fashion with members of the community, environmental organizations, regulators, and other stakeholders.

Since 2003, MRC's annual harvest has averaged 33.4 million board feet of conifer (redwood and Douglas fir) logs. EBITDA attributable solely to MRC's harvest and its fiber-based share of related mill and distribution business, net of capital spending, has averaged \$4.7 million per year. While some might consider this level of cash earnings modest for the size of MRC's forest, meeting the high standards of FSC management requires higher costs than a traditional industrial approach. And, these cash returns are supplemented by growth in timber volume that is not harvested. In MRC's case, the extra timber grown but not harvested has averaged roughly 60 million board feet per year since MRC's inception in 1998.

### **4.2. MRC Has Many Similarities with the Debtors.**

The operations of MRC and the Debtors have many similar characteristics, including the similarities of the counties where their main operations are located, as illustrated in the following:

**County Statistics – Mendocino and Humboldt County**

	Mendocino	Humboldt
<b>Population</b> <sup>1</sup>		
2000 Census	86,265	126,518
2005 <sup>7</sup>	88,276	128,359
<b>Annual Population Growth</b> <sup>1</sup>		
April 2000 - July 2006	0.35%	0.24%
<b>Median Household Income (MHI)</b> <sup>1</sup>		
2004	\$36,624	\$33,281
<b>Per Capita Income (PCI)</b> <sup>7</sup>		
2005	\$29,117	\$27,932
<b>Per Capita Income as a % of State Average (2005)</b> <sup>7</sup>		
California	78.83%	75.62%
<b>Size of County (in acres)</b> <sup>3</sup>	2,000,000	2,300,000
<b>Size of County (in square miles)</b> <sup>3</sup>	3,509	3,573
<b>Miles from San Francisco (southern border)</b> <sup>4</sup>	84.70	191.50
<b>Miles from San Francisco (northern border)</b> <sup>4</sup>	191.50	328.60
<b>Population Density (people per square mile)</b> <sup>1</sup>	24.6	35.4
<b>New Homes built in last year (single family dwellings)</b> <sup>3</sup>		
2007 County - Unincorporated	196	223
<b>New homes built in last 5 years (single family dwellings)</b> <sup>3</sup>		
2003-2007 County - Unincorporated	1,396	1,350
<b>Value of Average Home</b>		
Nov 2007 Median Prices - Houses Sold <sup>2</sup>	\$385,000	\$299,000
<b>Unemployment</b> <sup>5</sup>		
2006	5.20%	5.60%
<b>Total Harvest</b> <sup>6</sup>		
2006	114 mmbf	401 mmbf
2005	125 mmbf	460 mmbf
2004	119 mmbf	484 mmbf

<sup>1</sup> US Census Bureau (CA Quick Facts)

<sup>2</sup> Humboldt Economic Index / HSU

<sup>3</sup> Mendocino & Humboldt Counties

<sup>4</sup> Google Maps

<sup>5</sup> Employment Development Department

<sup>6</sup> State Board of Equalization

<sup>7</sup> Bureau of Economic Analysis

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**TIMBERLANDS – MRC VS SCOTIA PACIFIC**

<u><i>Timberlands</i></u>	<u><i>MRC</i></u>	<u><i>Palco</i></u>
Acres Of Forest Land	218,231	209,960
Miles Of Roads On Lands <sup>1</sup>	2,400	1,679
Miles Of Streams (class I & II) <sup>1</sup>	1,034	1,017
Standing Inventory Of Merchantable Conifers (net MBF) <sup>2</sup>	2,676,405	[redacted]
Unrestricted Standing Inventory Of Merchantable Conifer (net MBF) <sup>3</sup>	1,542,085	[redacted]
Average Harvest Last Five Years (2003 to 2007) MBF net	33,106	[redacted]
Average Expected Harvest next 5 years (net MBF)	38,000	[redacted]
Average Annual All Forestry Costs Other Than Log And Haul And Road expenditures (projected next 5 years) <sup>4</sup>	\$9,600,000	\$15,200,000
Average Annual Road Expenditures (projected next 5 years) <sup>5</sup>	\$3,100,000	[\$redacted]
Forest Related Employees ( <i>Road Dept. not included</i> )	60	83

<sup>1</sup> Palco HCP/MRC GIS

<sup>2</sup> Palco Intralink Data 4.1.21 (includes OGR)

<sup>3</sup> MRC vol. 1/07 MRC State of Inventory/Palco Intralink Data 4.4.18. Newco vol. per MRC

Note: Volumes are net harvestable in as they include volume on acres with BA residual limitations

<sup>4</sup> Proposed budget

<sup>5</sup> MRC & Scopac budgets \*5, plus 3% per Newco 5 year budget

<sup>6</sup> Based on initial estimate of annual harvest.



**4.3. MFP's Background.**

MRC's affiliate, MFP, successfully operates a sawmill and related distribution business in Ukiah, California. In recent years, MFP has primarily served Home Depot. In the course of their relationship, Home Depot has named MFP its Environmental Partner of the Year, and more recently, Home Depot's Lumber Department's Vendor of the Year (Home Depot purchases about \$6 billion in lumber from suppliers every year). MFP's Ukiah sawmill produced approximately 55 million board feet of redwood lumber in 2007, operating one shift of production. MFP's distribution business sells approximately 190 million board feet of redwood lumber and complementary forest products. In addition, MFP recently acquired a new affiliate that sells an additional 190 million board feet of forest products to a well diversified group of 650 customers, including one national Big Box customer. Many of these 650 customers fit the profile of traditional retailers of redwood lumber.

MFP has been successful over time, despite the fact that it operates a modest sized sawmill on only one shift, in conjunction with a related distribution business. MFP's operations are coordinated with MRC's timberlands to allow MFP to produce lumber based on market demand and with a sawmill that is matched to the harvest capacity of logs from MRC lands and logs easily available for purchase from other forest landowners in the region. The success of MFP has been a function of

- matching sawmill capacity to log harvest;
- producing and maintaining lumber inventory in anticipation of market demand; and
- providing just in time delivery service with a high degree of accuracy and dependability for wholesalers and retailers of redwood lumber.

In addition, MFP has achieved better service for its customers and strengthened its overall business by distributing additional lumber products that complement its redwood product line. MFP revenues of non-redwood products are roughly equal to its revenues of redwood products. MFP believes that redwood lumber's future success will require distribution capabilities that extend to complementary products, creating an attractive, diverse product offering to shore up redwood's declining market share among the breadth of competing products.



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MFP's mill operations and the Debtors' Mill have many similarities:

**SAWMILL – MENDOCINO FOREST PRODUCTS UKIAH MILL VS PACIFIC LUMBER COMPANY’S SCOTIA MILL**

<u>Mill</u>	<u>MFP</u>	<u>Palco</u>
Mill Average Production Rate	30 mbf/hr	[redacted] <sup>1</sup>
Average Fully Loaded Mill Conversion Costs	\$115/mbf	[redacted]
Fence Line Average Production Rate	12 mbf/hr	[redacted]
Average Fence Line Conversion Costs (direct)	\$54.07	[redacted]
Average Log Length	13.15ft	[redacted]
Average Mill Uptime	90.00%	90.00% <sup>3</sup>

<sup>1</sup> Intralink Section 5.0; Debtors 004246 5.2.4.04 Operating Metrics-September YTD-Unstamped

<sup>2</sup> Intralink 0.1.09 Debtors 008754-55 Sawmill Data

Note: Conversion costs shown in \$ per gross mbf and December 2007 costs are forecasted

<sup>3</sup> Estimates by MFP

**4.4. Business Strategy for Newco**

As part of the reorganization of the Debtors, MRC has developed a business strategy for Newco based on its expertise and its experience in managing MRC's integrated commercial redwood timberland, sawmill and lumber distribution operations in nearby Mendocino County.

**(a) Changes in the Debtors' Forestry Practices.**

First and foremost, MRC will, as soon as practicable, institute new forestry practices of for Newco, including the following:

- Bring all of the applicable forest practices, policies and procedures that MRC has used in the last 10 years to Newco;
- Immediately seek Forest Stewardship Council certification;
- Honor all aspects of the HCP entered into in conjunction with the Headwaters Agreement, and, subsequently, to the extent regulators and non-governmental organizations wish to seek to improve the implementation of the HCP, work with stakeholders to do that;
- Set the harvest rate initially at [redacted] board feet based on a detailed review of all acres available for harvest for the next 15 years combined with MRC’s forest practices;<sup>4</sup> and

<sup>4</sup> MRC has carefully reviewed all available information to estimate realistic and attainable harvest rates for the foreseeable future. For the short term, MRC has estimated harvest by assessing all harvestable acres for the next 15 years, growing stand inventories until time of harvest, and harvesting all available acres for harvest between now and year 15 utilizing harvest practices consistent with MRC’s operations in Mendocino County. Acres available for harvest was determined by reviewing all acres on Pacific Lumber Company lands and eliminating from harvest consideration (i) any “restricted acres” due to watercourses, habitat conservation plan commitments, or other identified regulatory constraints; (ii) any acres with less than 10,000 board feet per acre;

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- Inventory the forest and develop a long term spatially specific long-term harvest plan through a public process over an 18 to 24 month public process, which inventory will include increases in conifer inventory, increases in endangered species habitat, and smoothed changes in harvest (to avoid economic shocks) as objectives in the long term harvest plan (MRC does not expect the long term harvest plan would result in significant increases in harvest above [redacted] million board feet in the first 10 years of management).

### (b) Integration of the Timberlands and Mill to Maximize Value.

Successful operators of redwood timberlands must operate related processing and distribution businesses to maximize the long term value of their lands. Of the four major redwood timberland owners, only one is not integrated and this non-integrated redwood landowner has relied heavily on land sales in the last 5 years to achieve acceptable financial returns. A successfully integrated redwood landowner can avoid the need for land sales to achieve acceptable financial returns through integration. An integrated operation also maintains more local employment and tax revenue.

The Debtors' experience with having separated the Mill from the Timberlands has been destructive of value. For Newco, MRC would incorporate substantial lumber distribution activities as a final step in the operation of the Mill to obtain maximum value for the redwood lumber derived from the Timberlands.

Integration of the Mill and Timberlands will allow Newco to benefit from better manufacturing and marketing of redwood lumber. By incorporating MFP's lumber distribution experience, service to lumber retailers will be substantially improved. The best way to maximize the value of the Timberlands is to have consumers value the end finished lumber products that are derived from the Timberlands. Redwood lumber is the major product of opportunity for this increase in value. By contrast, Douglas fir is more of a commodity and end users of that product will not care where that type of wood came from.

Historically, redwood landowners have been unable or unwilling to support marketing of redwood lumber or service for redwood lumber distribution. However, MRC and MFP have successfully worked together to better market redwood lumber and to provide better service to redwood lumber customers.

To maximize value from the integration of the Mill and Timberlands, MRC and MFP will take the following actions:

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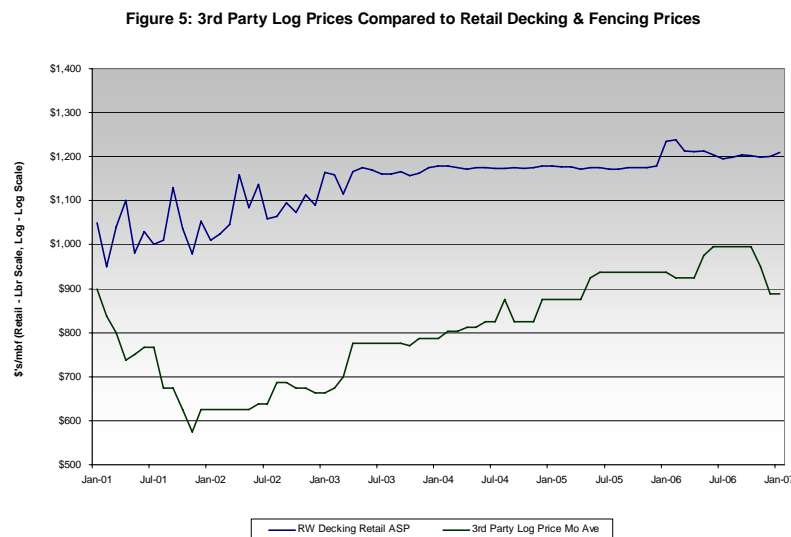
(iii) any acres harvested in the last ten years with remaining stocking of less than 20,000 board feet; (iv) any acres that are in too small of a stand to be economically harvested (typically a 10 acre stand is required to be economic). This proposed harvest level was further constrained by estimates of water quality restrictions in the Freshwater and Elk watersheds in particular, as well as the permanent elimination of traditional clear-cutting from the Timberlands.

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- Orient Mill and distribution of redwood to what the customers want, as opposed to what the Mill wants to produce;
- Market the attributes of redwood that customers value to increase the desirability of redwood to consumers for the long term;
- Provide outstanding service to distribution customers, and
- Sell additional products to redwood customers to create more efficiency for providing outstanding service.

Integration of the Mill and Timberlands will allow Newco to capture of “return to the log” in periods of weak lumber demand. Lumber is a cyclical product, and will have periods of declining demand due to end use in construction, as is the case today. As lumber inventory stacks up, sawmills drop log prices to slow fiber supply into the sawmill. Decreasing lumber prices will not stimulate demand in a period of weak lumber demand. Lower log prices appear to reduce harvesting particularly amongst non industrial landowners.

A well-managed and integrated sawmill will help insulate a landowner from declining log values to the extent lumber prices decline less than log prices. In the case of redwood, log prices have been much more volatile than lumber prices, as illustrated in the following chart:



Specific steps to be taken to maximize value from the Mill and Timberlands include the following:

- Investment of \$7.5 million in new capital by Newco in the Mill to make the Mill flexible enough to handle the logs produced by the Timberlands and reduce costs of processing to the level achieved by MFP’s Ukiah sawmill;
- Newco will match production of the Mill to the harvest rate and size of the logs being harvested from the Timberlands;

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- Newco will change the strategy of the Mill to produce what the market wants to buy, as opposed to what can be produced in high volume or low cost;
- Newco will work to rebuild customer relationships that have been frayed in recent years due to poor customer service by the Debtors; and
- Newco will develop redwood lumber distribution capabilities, and/or utilize existing distribution infrastructure of MFP and its affiliates to better market redwood lumber and to better serve customers with redwood lumber and complementary forest products.

### **(c) Newco Will Achieve Significant Synergies With MRC And MFP**

MRC and MFP's existing management, operations, and experience will provide substantial synergies to Newco. The ability to realize these benefits are unique to MRC and MFP due to the similarity of MRC and MFP's business to Newco, as well as MFP and related affiliates already distributing almost 400 million board feet of redwood lumber and complementary forest products. Synergies that will be realized and benefit Newco will include:

- Eliminate duplicative senior management positions (estimated annual savings of \$1.5 million);
- Consolidate redundant information system costs (estimated annual savings of \$0.5 million);
- Eliminate duplicative sales, sawmill administration, and accounting administration positions (estimated annual savings of \$0.25 million);
- Unify forestry science, inventory and GIS departments (estimated annual savings of \$0.5 million); and
- Utilize existing distribution facilities, capabilities, and relationships at MFP and its Affiliate to sell redwood lumber and related products to existing customers and retain the resulting economic benefits for Newco (estimated avoided cost of \$6 million annually).

In addition, MRC will combine MRC and Newco Douglas Fir harvests to establish an FSC Certified Douglas Fir Lumber program on behalf of a Big Box retailer. This program will assure an ability to move Douglas Fir lumber in down markets such as the one that exists today.

### **(d) Management of Newco.**

MRC and MFP have worked with a stable and experienced group of individuals to develop a strong cohesive and effective management team. MRC and MFP would utilize their entire existing management team to address the changes that need to be implemented at Newco.. Members of the management team for Newco will include:

**Richard Higgenbottom** is Chief Executive Officer for MRC and MFP. His biography is included below for Newco's Board of Directors.

**Michael E. Jani** is President and Chief Forester of Timberland Operations for MRC. Mr. Jani joined the company in May of 1999 as Chief Forester. He successfully led MRC's initiative to demonstrate that it is possible to manage a large block of forestland utilizing high standards of environmental stewardship and at the same time operate a successful business. These efforts were recognized in November 2000 when MRC achieved FSC certification by the Forest Stewardship Council through their rigorous certification process. Mr. Jani has 34 years experience in the redwood business. Prior to joining the company, he worked for Big Creek Lumber Company in Santa Cruz County, California for 24 years, where he held a number of positions, including Chief Forester. Big Creek was the first company in California's redwood region to be certified under the Forest Stewardship Council's program. Mr. Jani also received FSC certification as a Professional Resource Manager. He is a member of the Society of American Foresters, the Forest Stewards Guild, and the Forest Stewardship Council and has been an active participant with The Society of American Foresters and the Farm Bureau. More recently, he has participated in the development of the FSC Pacific Coast standards; he sits on the Board of Directors for the FSC-US and the State Forestry Advisory Committee and is a member of Cal Poly's and Berkeley's Forestry School's Curriculum Advisory Council. Mr. Jani is a valued and respected resource on forestland stewardship issues at the local, state and national levels. Mr. Jani graduated from the University of California, Berkeley, with a B.S. in Forestry, is a state Registered Professional Forester and has attained national certification as a Specialist in Sediment and Erosion Control.

**John L. Russell** is President of Sawmill and Distribution operations for MFP. Mr. Russell has been with the company for almost ten years, having joined the company in 1998 as part of the original acquisition from Louisiana Pacific, and has 20 years experience in the redwood business. Mr. Russell has held a number of positions throughout the years, including Western Division Sales Manager, Director of Distribution and most recently Senior Vice President of Sales and Marketing. Prior to joining Louisiana Pacific, Mr. Russell began his career at Wisconsin-California Forest Products. He currently serves as Vice Chairman of the Board for the California Redwood Association, and is a member of the Lumber Association of California and Nevada, and the Home Depot Foundation Advisory Committee. He holds a B.A. from the University of California, Santa Barbara, and studied Forestry at Humboldt State University.

**Martin R. Olhiser** is Senior Vice President for MFP. Mr. Olhiser joined the company in 1998 as part of the original acquisition from Louisiana Pacific, and he has 38 years experience in the redwood business. Prior to his current role, he was the Executive Vice President, Manufacturing and Sawmill Sales, Treating and Distribution. While at Louisiana Pacific, Mr. Olhiser was the Business Manager for the Wholesale, Treated Wood, and Distribution businesses, as well as having been Sales & Marketing Manager. His previous experience includes managing the startup and operation of two distribution businesses. Mr. Olhiser currently serves as a Board member for TrueGuard, LLC, the California Redwood Association, and the Timber Advisory Committee to the California State Board of Equalization representing large timber owners. Previously, Mr. Olhiser

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was the Chairman of the Board for the California Redwood Association. Marty holds an AA degree in Business Administration from Santa Rosa Junior College.

**James Pelkey** is Chief Financial Officer for MRC and MFP. He joined the company in 2004, and has over 16 years experience in finance and accounting. Mr. Pelkey began his career in public accounting, spending 4 years with both Arthur Andersen & Company and Price Waterhouse & Company in Boston, MA and San Francisco, respectively. Upon leaving Price Waterhouse, Mr. Pelkey spent 7 years in various management positions in the financial services and consumer products industries. In 5 years with Dartford Partnership, he participated in several acquisitions, procuring acquisition financings for several transactions in the consumer products industry. Additionally, he participated in several initial public offerings while with Dartford. Mr. Pelkey has a B.S. degree in Business Administration from Northeastern University, and an M.S. degree in Accounting from Bentley College, and is a Certified Public Accountant.

**Thomas Schultz** is Asset Manager for MRC and has over 30 years experience in the redwood business. Tom transitioned to MRC as the Timberlands Manager as part of the original acquisition from Louisiana Pacific in 1998. He is a Registered Professional Forester, and holds a B.S. degree from Humboldt State University in Forestry. Mr. Schultz is the current Chairman of the Mendocino County Cooperative Aerial Fire Patrol, Associate Director/Nominated Director of the Mendocino County Resource Conservation District, and a board member of the Noyo River Watershed Alliance. Mr. Schultz has been Past President of the Salmon Restoration Association, Past Director of the California Licensed Foresters Association, and a past member of Mendocino County General Plan Citizens Advisory Committee and the Garcia River Watershed Advisory Committee.

**Adam Steinbuck** is Timberlands Manager for MRC. He has been in the redwood business for over 13 years, 9.5 with MRC. Previous positions with Mendocino Redwood Company include Asset Manager, Forest Science Manager, and Stewardship Director. Prior to joining the company, he worked for Louisiana Pacific as a Forester and Logging Supervisor. Mr. Steinbuck is the Chairman of the Leadership Mendocino Steering Committee, is a member of the California Licensed Foresters Association and is on the Advisory Committee for the Redwood Valley Outdoor Education Program. He was also Past President/Director for the Redwood Region Logging Conference. Mr. Steinbuck is a Registered Professional Forester, and holds a B.S. in Forestry from Humboldt State University.

**Sarah Billig** is Stewardship Director for MRC, having joined the company in 2001. In addition to her current position, she has held a variety of Biologist positions with MRC. She is a current member of the Western Section of the Wildlife Society, the Society for Conservation Biology, and on the Leadership Mendocino Steering Committee. Ms. Billig holds a B.S. degree from the University of Michigan in Natural Resources.

**John Arlich** is Quality Assurance Analyst for MFP, having been with the company since the original acquisition from Louisiana Pacific in 1998, and brings over 30 years

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experience in the redwood business. Prior to transitioning to MFP, John held a variety of positions with Louisiana Pacific including Quality Control Supervisor, Plant Manager – LP de Mexico, and Regional Quality Control Manager. Mr. Arlich is the Chairman for the Redwood Inspection Service Quality Standards Committee. He is a certified Lumber Grader by the Redwood Inspection Service, West Coast Lumber Inspection Bureau, & Western Wood Products Association, and has recently received certification as a Six Sigma Green Belt.

**Doug McIsaac** is the Sawmill Production Supervisor for MFP. Mr. McIsaac has over 28 years experience in the redwood business, having been with the company for 9.5 years since the original acquisition from Louisiana Pacific in 1998.

**James Russell** is In-House Counsel and Director, Administration for MFP. He joined the company in 2005 as Director, Materials and Logistics/Distribution, and has over 10 years experience in the redwood business. Prior to MFP, he was General Manager for Siskiyou Lumber Products. He holds a B.S. from the University of California at Davis, and a J.D. from the University of Pacific, McGeorge School of Law. Mr. Russell is a current member of the California State Bar Association.

### **(e) Directors for Newco.**

Newco will be governed by a five member Board of Directors. The Board will have substantial overlap with the existing MRC and MFP Boards. Marathon will have an investment in Newco but will not have an investment in MRC and MFP, and thus Marathon will be the arbiter of any items that could be a conflict between the two businesses. Objective procedures have been agreed to in advance to deal with any conflicts that could arise in the ordinary course of business (such as splitting cost of human resources who might spend time on both businesses or for the transfer of logs or lumber from one business to the next). Directors will include:

**Sandy Dean** has served as the Chairman of the Board for MRC, MFP and TrueGuard, LLC since these boards were formed in 2000, and he will serve as the Chairman of Newco. He has spent 9 ½ years with MRC and MFP, including the first two years as President of both companies. He was involved on a day-to-day basis as part of the original acquisition from Louisiana Pacific in 1998. He is a co-founder of Sansome Partners, LP in 1997, and remains a partner in the firm which is dedicated to making direct investments on behalf of the Fisher family. Prior to founding Sansome, Mr. Dean was a Partner with Blum Capital Partners, L.P. At Blum, he worked on sourcing, structuring, and managing both private and public equity investments. Prior to joining Blum, Mr. Dean worked in the leveraged buyout group of Brentwood Associates in Los Angeles and also as a financial analyst at Goldman, Sachs & Co. in New York. He has been involved in an oversight capacity with a number of private businesses, and has served on several not-for-profit boards. Sandy has a B.S.E from Duke University and an M.B.A. from the Graduate School of Business at Stanford University.

**John Fisher** has been a Director since the formation of MRC and MFP Boards in 2000. John is a co-founder of Sansome Partners, LP and he currently is the President of Pisces,

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Inc., a company started in 1992 as a family investment and management office for the Fisher family. Prior to starting Pisces, Mr. Fisher was a project manager at Carpenter & Company, a Boston-based real estate development firm. He currently serves on the Advisory Board of the Hotel Equities Fund and has served on the boards of a number of private companies. He has a B.A from Princeton University and an M.B.A. from the Graduate School of Business at Stanford University.

**Richard Higgenbottom** is Chief Executive Officer for MRC and MFP. Mr. Higgenbottom joined the companies in 2000, bringing executive experience in manufacturing, distribution, and marketing. Under his guidance, MFP has expanded its partnership with its customer by increasing distribution markets and product lines through innovative approaches to distribution, supply chain management, operational efficiency, marketing, merchandising and customer service. He has been instrumental in providing leadership supporting the company's initiatives of high environmental stewardship standards, and FSC Certification. Prior to joining the company, Richard has held progressively responsible positions in engineering, product development, profit and loss accountability, and supplying products to Original Equipment Manufacturers, wholesalers and retail markets. He currently serves as Treasurer of the California Forestry Association, an organization committed to keeping its members and the public informed of issues surrounding efforts to keep California forests healthy, sustainable and well-managed for water, wildlife, the economy and protected against disease and wildfire. He has a B.S. in Industrial Technology, College of Engineering, Tennessee Technological University.

**Thomas Paper** has been a Director since the formation of MRC and MFP Boards in 2000. He was the former Chief Financial Officer of MRC and MFP from 1999 through 2002. Mr. Paper received a BA in Economics from Williams College and an M.B.A. from the Graduate School of Business at Stanford University. He is currently the Managing Partner of Webster Pacific LLC, a strategic and financial consulting firm, formed in 2003. Mr. Paper is also a Director of Lewis Bolt & Nut Company and a Board Member to the Gateway High School in San Francisco, the St. Francis Memorial Hospital and the Turnaround Management Association of San Francisco.

**Richard K. Ronzetti** is the Executive Managing Director and Global Head of Investment Management at Marathon. As a member of Marathon's Executive and Investment Committees, Mr. Ronzetti is responsible for coordinating Marathon's private equity activities with the Investment Committee. Mr. Ronzetti also oversees restructurings, distressed investments, investment research and credit analysis for Marathon, including private finance investments. Prior to joining Marathon, Mr. Ronzetti worked at Morgan Stanley & Co. and Drexel Burnham Lambert as an investment banker in the corporate finance and financial institutions departments and at Agnelli Group's U.S. private equity arm where he was a Senior Investment Analyst responsible for the analysis of private equity investments in Latin America and several private equity investments and restructurings in the United States. Mr. Ronzetti also has experience serving as a Managing Director and Head of Emerging Markets and International High Yield research, among other roles in research and corporate finance, at several Wall Street



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firms including Paine Webber, Inc. and Smith Barney. Mr. Ronzetti holds a Bachelor of Arts degree, cum laude, in Government and Economics from Harvard College and a Master of Business Administration degree from the Harvard University Graduate School of Business Administration.

### **(f) Implementation of Strategy.**

#### **(1) Management.**

With the benefit of an intact management team, the Debtors can cease their practice of relying on a parade of strategy consultants, operation consultants, financial consultants and forestry experts from other areas of the country, all of whom have brought different ideas to the Debtors without any principal downside if their ideas fail to be successful. Relying on operational and financial goals that have been formulated by MRC and its tenured management team from the redwood region will allow Newco to meet its commitments going forward.

#### **(2) Coordination with MRC and MFP.**

Newco will also closely coordinate its operations with MRC and MFP. While operating as separate companies and they will share best practices for producing high quality products for the lowest cost possible.

#### **(3) Start-up.**

A \$5 million operations expense reserve will be established to cover inefficiencies at Newco during the early transition months. Providing a sufficient number of Newco mill employees volunteer and sufficient log supply is available, MFP is prepared and willing to staff a second shift at the Ukiah mill to offset any Newco mill downtime during the initial period of capital redesign and retooling. An appropriate per diem would be provided to cover meals, lodging and weekly travel for each volunteer. In addition, a process to enable employees to transfer across affiliate companies will be explored.

#### **(4) Employment.**

Over time, Newco and MRC will try to standardize, where possible, providing fair and competitive wages, benefits and incentives. This will provide expanded training, development and professional growth to all employees. A process to enable employees to transfer across Newco and MRC will be explored.

### **4.5. Summary of Benefits to be Realized.**

Operational benefits to be realized from MRC's plan for Newco include:

- Committed capital, new management, and operational plans that are all available to be utilized by Newco today.

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- Realization of significant synergies through the management, operations and experience delivered by MRC and MFP
- Bring the successful forestry practices of MRC to Newco, and immediately seek Forest Stewardship Council certification of exemplary practices;
- Integration of the Timberlands and Mill, thereby avoiding the need to pursue land sales as an ordinary course measure for achieving acceptable financial returns;
- MRC and MFP management dedicated to investing in the Scotia mill for its long term success, thereby maximize long term employment in Humboldt County and preserving the identity of Scotia as a successful lumber mill town;
- Better marketing of redwood products, and better service for redwood lumber retailers, maximizing the value of redwood products to the end consumer for the long term and thereby creating the most resources to be available to invest in the health of the forest for the future in a fashion similar to what has been achieved at MRC;
- A higher standard of management working to achieve more productive and efficient relationships with all the regulatory agencies overseeing the Timberlands; and
- Creditors to receive substantial recoveries based on the infusion of \$225 million of new cash equity.

### **SECTION 5.**

#### **SUMMARY OF THE PROPOSED PLAN OF REORGANIZATION**

##### **5.1. General.**

The purpose of the Plan is to implement the Plan Proponents restructuring based on a capital structure that can be supported by cash flows from operations. The Plan Proponents believe that the reorganization contemplated by the Plan is in the best interests of the Holders of Allowed Claims and Interests. If the Plan is not confirmed, the Plan Proponents believe that the Debtors may be forced to liquidate under chapter 7 of the Bankruptcy Code and receive substantially lower recoveries. See the Liquidation Analysis attached to this Disclosure Statement as Exhibit C.

The following is a summary of certain key provisions of the Plan. Before voting, persons who have Claims are referred to, and encouraged to review, the relevant provisions of the Plan, the other Plan Documents, and the Bankruptcy Code carefully since their rights could be affected. They also are encouraged to review the Plan and this Disclosure Statement with their counsel or other advisors. Note that other provisions of the Plan not summarized in this Section [4] may be summarized elsewhere in this Disclosure Statement.

**5.2. Overview of Chapter 11.**

Chapter 11 is the principal business reorganization chapter of the Bankruptcy Code. Under chapter 11, a debtor can reorganize its business for the benefit of itself, its creditors, and interest Holders. Chapter 11 also strives to promote equality of treatment for similarly situated creditors and similarly situated interest Holders with respect to the distribution of a debtor's assets.

The commencement of a chapter 11 case creates an estate that is comprised of all of the legal and equitable interests of a debtor as of the filing date. The Bankruptcy Code provides that the debtor may continue to operate its business and remain in possession of its property as a "debtor-in-possession.

The consummation of a plan of reorganization is the principal objective of a chapter 11 case. A plan of reorganization sets forth the means for satisfying claims against, and interests in, a debtor. Confirmation of a plan of reorganization makes the plan binding upon the debtor, any issuer of securities under the plan, any person or entity acquiring property under the plan, and any creditor of or equity holder in the debtor, whether or not such creditor or equity holder is impaired under or has accepted the plan, or receives or retains any property under the plan. Subject to certain limited exceptions, and except as otherwise provided in the plan or the confirmation order itself, a confirmation order discharges the debtor from any debt that arose prior to the date of confirmation of the plan and substitutes for those debts the obligations specified under the confirmed plan.

A chapter 11 plan may specify that the legal, contractual, and equitable rights of the holders of claims or interests in certain classes are to remain unaltered by the reorganization effectuated by the plan. Such classes are referred to as "unimpaired" and, because of such favorable treatment, are deemed to accept the plan. Accordingly, a debtor need not solicit votes from the holders of claims or equity interests in such unimpaired classes. A chapter 11 plan also may specify that certain classes will not receive any distribution of property or retain any claim against a debtor. Such classes are deemed to reject the plan and, therefore, need not be solicited to vote to accept or reject the plan. Any classes that are receiving a distribution of property under the plan but are not "unimpaired" will be solicited to vote to accept or reject the plan.

Section 1123 of the Bankruptcy Code provides that a plan of reorganization must classify the claims of a debtor's creditors and equity interest holders. In compliance therewith, the Plan divides Claims and Interests into various Classes and sets forth the treatment for each Class. A debtor is also required, as discussed above, under section 1122 of the Bankruptcy Code, to classify claims and interests into classes that contain claims and interests that are substantially similar to the other claims and interests in such classes. The Plan Proponents believe that the Plan has classified all Claims and Interests in compliance with section 1122 of the Bankruptcy Code, but it is possible that a Holder of a Claim or Interest may challenge the classification of Claims and Interests and that the Bankruptcy Court may find that a different classification is required for the Plan to be confirmed. In such event, the Plan Proponents intend, to the extent permitted by the Bankruptcy Court and the Plan, to make such modifications of the classifications under the Plan to permit Confirmation and to use the Plan acceptances received in

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this solicitation for the purpose of obtaining the approval of the reconstituted Class or Classes of which the accepting Holder is ultimately deemed to be a member. Any such reclassification could adversely affect the Class in which such Holder was initially a member, or any other Class under the Plan, by changing the composition of such Class and the vote required of that Class for approval of the Plan.

THE REMAINDER OF THIS SECTION PROVIDES A SUMMARY OF THE STRUCTURE AND MEANS FOR IMPLEMENTATION OF THE PLAN AND THE CLASSIFICATION AND TREATMENT OF CLAIMS AND INTERESTS UNDER THE PLAN, AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO THE PLAN, THE PLAN SUPPLEMENT, AND THE EXHIBITS AND DEFINITIONS CONTAINED IN EACH DOCUMENT. THE STATEMENTS CONTAINED IN THIS DISCLOSURE STATEMENT INCLUDE SUMMARIES OF THE PROVISIONS CONTAINED IN THE PLAN AND IN THE DOCUMENTS REFERRED TO IN THE PLAN.

THE STATEMENTS CONTAINED IN THIS DISCLOSURE STATEMENT DO NOT PURPORT TO BE PRECISE OR COMPLETE STATEMENTS OF ALL THE TERMS AND PROVISIONS OF THE PLAN OR DOCUMENTS REFERRED TO IN THE PLAN, AND REFERENCE IS MADE TO THE PLAN AND TO SUCH DOCUMENTS FOR THE FULL AND COMPLETE STATEMENT OF SUCH TERMS AND PROVISIONS OF THE PLAN OR DOCUMENTS REFERRED TO IN THE PLAN.

THE PLAN ITSELF AND THE DOCUMENTS IN THE PLAN CONTROL THE ACTUAL TREATMENT OF CLAIMS AND INTERESTS UNDER THE PLAN, WILL, UPON THE OCCURRENCE OF THE EFFECTIVE DATE, BE BINDING UPON, AMONG OTHER ENTITIES, ALL HOLDERS OF CLAIMS AND INTERESTS, THE REORGANIZED ENTITIES, ALL ENTITIES RECEIVING PROPERTY UNDER THE PLAN, AND OTHER PARTIES IN INTEREST. IN THE EVENT OF ANY CONFLICT BETWEEN THIS DISCLOSURE STATEMENT AND THE PLAN OR ANY OTHER OPERATIVE DOCUMENT, THE TERMS OF THE PLAN AND SUCH OTHER OPERATIVE DOCUMENT SHALL CONTROL.

### **5.3. Overall Structure of the Plan.**

On or prior to the Effective Date, the Plan Proponents shall contribute \$225 million in Cash to Newco. Also on the Effective Date, the Debtors shall be reorganized into two newly formed Reorganized Entities, Newco and Townco, and, except as otherwise set forth herein, all of the Debtors' Assets shall be transferred to these Reorganized Entities free and clear of all Claims, Liens, charges, other encumbrances and Interests. On and after the Effective Date, the Reorganized Entities may operate their businesses, may use, acquire and dispose of property, may retain, compensate and pay any professionals or advisors, and compromise or settle any causes of action, claims or interests without supervision of or approval by the Bankruptcy Court and free and clear of any restrictions of the Bankruptcy Code or the Bankruptcy Rules other than restrictions expressly imposed by the Plan and the Confirmation Order.

**SECTION 6.  
SUMMARY OF THE PLAN**

**6.1. Definitions.**

As used in the Plan, capitalized terms not otherwise defined therein shall have the meanings specified in Appendix A, submitted contemporaneously herewith. Unless the context otherwise requires, any capitalized term used and not defined in the Plan, but that is defined in the Bankruptcy Code, shall have the meaning assigned to that term in the Bankruptcy Code.

**6.2. Rules of Construction.**

For purposes of the Plan, unless otherwise provided herein: (a) any reference in the Plan to a contract, instrument, document, release, indenture or other agreement, whether existing or contemplated, being in a particular form or on particular terms and conditions means that such contract, instrument, document, release, indenture or other agreement shall be substantially in such form or substantially on such terms and conditions; (b) unless otherwise specified, all references in the Plan to the Introduction, Articles, Sections, Schedules and Exhibits are references to the Introduction, Articles, Sections, Schedules and Exhibits of or to the Plan; (c) captions and headings in the Plan are intended for convenience of reference only and are not intended to be part of or to affect interpretation of the Plan; (d) the words "herein," "hereof," "hereunder," "hereto" and other words of similar import refer to the Plan in its entirety rather than to a particular portion of the Plan; (e) whenever it appears appropriate from the context, each pronoun stated in the masculine, feminine or neuter includes the masculine, feminine and neuter; and (f) the rules of construction set forth in section 102 of the Bankruptcy Code and in the Bankruptcy Rules shall apply.

**6.3. Computation of Time.**

In computing time prescribed or allowed by the Plan, unless otherwise expressly provided, Fed. R. Bankr. P. 9006(a) shall apply.

**6.4. Treatment of Administrative Expense Claims, Priority Tax Claims and Professional Compensation Claims against the Debtors.**

**(a) Administrative Expense Claims.**

On the later of (i) the Effective Date or (ii) the date on which an Administrative Expense Claim becomes Allowed, the Reorganized Entities shall either (x) pay to each Holder of an Allowed Administrative Expense Claim, in Cash, the full amount of such Allowed Administrative Expense Claim, or (y) satisfy and discharge such Administrative Expense Claim in accordance with such other terms that the Plan Proponents or the Reorganized Entities and such Holder shall have agreed upon in writing; *provided, however*, that such agreed-upon treatment shall not be more favorable than the treatment provided in subsection [(x)].

**(b) Bar Date for Filing Administrative Expense Claims.**

The Holder of an Administrative Expense Claim (other than an Administrative Expense Claim described in Article 2.3. of the Plan or an Administrative Expense Claim arising from the Palco DIP Loan) shall file with the Bankruptcy Court and serve on the appropriate Debtor and the Plan Proponents a request for payment of such Claim no later than the Administrative Expense Claims Bar Date. Such request shall be by motion and shall include at a minimum (a) the name of the Debtor(s) purported to be liable for the Administrative Expense Claim, (b) the name of the Holder of the Administrative Expense Claim, (c) the amount of the Administrative Expense Claim and (d) the basis for the Administrative Expense Claim. **Failure to file and serve such request timely and properly shall result in the Administrative Expense Claim being forever barred and discharged.** Unless the Plan Proponents, Debtors or the Reorganized Entities object to an Administrative Expense Claim within thirty (30) days after the Administrative Expense Claims Bar Date, such Administrative Expense Claim shall be deemed to be Allowed in the amount requested. In the event that there is an objection to an Administrative Expense Claim, the Bankruptcy Court shall determine the Allowed amount of such Administrative Expense Claim. Notwithstanding the foregoing, no request for payment of an Administrative Expense Claim need be filed with respect to an Administrative Expense Claim which is paid or payable by a Debtor in the ordinary course of its business and is not past due.

**(c) Professional Compensation Claims.**

Notwithstanding any other provision of the Plan dealing with Administrative Expense Claims, any Person seeking a Professional Compensation Claim shall, no later than sixty (60) days after the Effective Date, file a final application for allowance of compensation for services rendered and reimbursement of expenses incurred through the Effective Date. To the extent that such an award is granted by the Bankruptcy Court, the requesting Person shall receive, (a) payment of Cash in an amount equal to the amount Allowed by the Bankruptcy Court less all interim compensation paid to such Professional during the Reorganization Cases, such payment to be made within thirty (30) days after the Order granting such Person's final fee application becoming a Final Order, (b) payment on such other terms as may be mutually agreed upon by the Holder of the Professional Compensation Claim and the Plan Proponents or the Reorganized Entities (but in no event shall the payment exceed the amount Allowed by the Bankruptcy Court less all interim compensation paid to such Professional during the Reorganization Cases), or (c) payment in accordance with the terms of any applicable administrative procedures orders entered by the Bankruptcy Court, including the Interim Compensation Order, dated January 19, 2007.

**(d) Priority Tax Claims.**

Each Holder of an Allowed Priority Tax Claim against a Debtor shall receive payment on the Distribution Date of Cash in an amount equal to the unpaid portion of such Allowed Priority Tax Claim.

**(e) Treatment of Environmental Obligations.**

Notwithstanding any other provision in the Disclosure Statement or the Plan, as amended from time to time, the Debtors (including the Reorganized Entities, as of the Effective Date)

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shall comply, complete, perform, satisfy, and/or provide for satisfaction of any pre-petition, current, ongoing, executory, and future Environmental Obligations.

Each Environmental Obligation shall be satisfied in full in the ordinary course of business of the Debtors, or, as of the Effective Date, the Reorganized Entities, at such time and in such manner as the Debtors and the Reorganized Entities are obligated to satisfy such Environmental Obligation under applicable non-bankruptcy law.

Each Environmental Obligation shall survive the Effective Date of the Plan as if the Reorganization Cases had not been commenced, shall not be discharged under section 1141(d) of the Bankruptcy Code, and shall not otherwise be adversely affected by the Reorganization Cases.

Moreover, the Agreement Relating to Enforcement of AB 1986, including all restrictions and obligations set forth in Section 3.1 therein, are and shall remain recorded as valid covenants, conditions and restrictions (the "CC&Rs") which run with the land and remain binding on successors and assigns, and shall be senior in priority to all Liens provided in the Plan as to the land on which the CC&Rs affect.

### **(f) Treatment of Post-Petition Tax Claims.**

Any Tax Claim against any of the Debtors that first arose on or after the Petition Date, shall, prior to the Effective Date, be timely paid by the Debtors or, as of the Effective Date, the Reorganized Entities, as the case may be, in the ordinary course of their business or shall be subject to applicable state-court or federal-court, collection efforts without further recourse to the Bankruptcy Court.

## **6.5. Classification of Claims against and Interests in Debtors.**

### **(a) Classification of Claims.**

Pursuant to section 1122 of the Bankruptcy Code, set forth below is a designation of Classes of Claims against and Interests in the Debtors. A Claim or Interest is placed in a particular Class for the purposes of voting on the Plan and of receiving Distributions pursuant to the Plan only to the extent that such Claim or Interest is an Allowed Claim or Allowed Interest in that Class and such Claim or Interest has not been paid, released, withdrawn or otherwise settled prior to the Effective Date. In accordance with section 1123(a)(1) of the Bankruptcy Code, Administrative Expense Claims and Priority Tax Claims of the kinds specified in sections 507(a)(2) and 507(a)(8), respectively, of the Bankruptcy Code have not been classified and their treatment is set forth in Article II of the Plan. Additionally, claims arising under the Debtors' pre-petition pension and workers' compensation plans and programs have not been classified and their treatment has been set forth in Article IV of the Plan.

(b) **Classes.**

The Claims against and Interests in the Debtors are classified as follows:

- (1) **Class 1: Other Priority Claims.**
- (2) **Class 2: Other Secured Claims.**
- (3) **Class 3: Palco DIP Loan Claim.**
- (4) **Class 4: Palco Term Loan Claim.**
- (5) **Class 5: Scopac Loan Claims.**
- (6) **Class 6: Scopac Timber Note Secured Claims.**
- (7) **Class 7: Palco Trade Claims.**
- (8) **Class 8: Scopac Trade Claims.**
- (9) **Class 9: Scopac Timber Note Unsecured Claims.**
- (10) **Class 10: Palco General Unsecured Claims.**
- (11) **Class 11: Scopac General Unsecured Claims.**
- (12) **Class 12: Inter-Debtor Claims.**
- (13) **Class 13: Non-Debtor Affiliate Claims.**
- (14) **Class 14: Interests in the Debtors.**

6.6. **Treatment of Claims and Interests and Designation With Respect To Impairment.**

(a) **Treatment of Class 1 - Other Priority Claims.**

(1) **Impairment and Voting.**

Class 1 is unimpaired by the Plan. Each Holder of an Allowed Other Priority Claim is conclusively presumed to have accepted the Plan and is not entitled to vote to accept or reject the Plan.

(2) **Treatment.**

On the Distribution Date, each Holder of an Allowed Other Priority Claim shall receive from the Reorganized Entities, in full satisfaction, release and discharge of and in exchange for such Claim, (i) payment of Cash in an amount equal to the unpaid portion of such Allowed Other



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Priority Claim, plus Post-petition Interest, or (ii) such other treatment that the Plan Proponents or the Reorganized Entities and such Holder shall have agreed upon in writing; *provided, however*, that such agreed-upon treatment shall not be more favorable than the treatment provided in subsection (i).

**(b) Treatment of Class 2 - Secured Tax Claims.**

**(1) Impairment and Voting.**

Class 2 is unimpaired by the Plan. Each Holder of an Allowed Secured Tax Claim is conclusively presumed to have accepted the Plan and is not entitled to vote to accept or reject the Plan.

**(2) Treatment.**

On the Distribution Date, each Holder of an Allowed Secured Tax Claim shall receive from the Reorganized Entities, in full satisfaction, release and discharge of and in exchange for such Claim, (i) payment of Cash in an amount equal to the unpaid portion of such Secured Tax Claim plus Post-petition Interest (at a rate to be determined under applicable non-bankruptcy law), or (ii) such other treatment that the Plan Proponents or the Reorganized Entities and such Holder shall have agreed upon in writing; *provided, however*, that such agreed-upon treatment shall not be more favorable than the treatment provided in subsection (i).

**(c) Treatment of Class 3 – Palco DIP Loan Claim.**

**(1) Allowance of Claim, Impairment and Voting.**

The Palco DIP Loan Claim is Allowed in full in the approximate principal amount of \$75 million, plus interest, fees and other expenses, without offset, defense or counterclaim, and shall not be subject to objection, subordination, recharacterization, or any claim under chapter 5 of the Bankruptcy Code. Class 3 is impaired by the Plan. The Holder of the Allowed Palco DIP Loan Claim is entitled to vote to accept or reject the Plan.

**(2) Treatment.**

On the Effective Date, the Allowed Class 3 Palco DIP Loan Claim and the Allowed Class 4 Palco Term Loan Claim shall be assigned to Newco, and in full satisfaction, release and discharge of and in exchange for both the Allowed Class 3 Palco DIP Loan Claim and the Allowed Class 4 Palco Term Loan Claim and the contribution by Marathon described in Section 7.1 below, Marathon (1) shall receive 100% equity ownership interest of Townco, (2) shall receive a [15%] equity ownership interest in Newco (subject to adjustment), and (3) shall receive a promissory note from Newco in the aggregate approximate principal amount of \$25 million secured solely by Liens on the Mill Working Capital.

**(d) Treatment of Class 4 – Palco Term Loan Claim.**

**(1) Allowance of Claim, Impairment and Voting.**

The Palco Term Loan Claim is Allowed in full in the approximate principal amount of \$85 million, plus interest, fees and other expenses, without offset, defense or counterclaim, and shall not be subject to objection, subordination, recharacterization, or any claim under chapter 5 of the Bankruptcy Code. Class 4 is impaired by the Plan. Marathon, the Holder of the Allowed Palco Term Loan Claim is entitled to vote to accept or reject the Plan.

**(2) Treatment.**

On the Effective Date, the Allowed Class 3 Palco DIP Loan Claim and the Allowed Class 4 Palco Term Loan Claim shall be assigned to Newco, and in full satisfaction, release and discharge of and in exchange for both the Allowed Class 3 Palco DIP Loan Claim and the Allowed Class 4 Palco Term Loan Claim and the contribution by Marathon described in Section 7.1 below, Marathon (1) shall receive 100% equity ownership interest of Townco, (2) shall receive a [15%] equity ownership interest in Newco (subject to adjustment), and (3) shall receive a promissory note from Newco in the aggregate approximate principal amount of \$25 million secured solely by Liens on the Mill Working Capital.

**(e) Treatment of Class 5 – Scopac Loan Claim.**

**(1) Impairment and Voting.**

The Scopac Loan Claim is Allowed in full in the approximate principal amount of \$[\_\_\_\_] million, plus interest, fees and other expenses, without offset, defense or counterclaim and shall not be subject to objection, subordination, recharacterization, or any claim under chapter 5 of the Bankruptcy Code. Class 5 is unimpaired by the Plan. Bank of America, the Holder of the Allowed Scopac Loan Claim is conclusively presumed to have accepted the Plan and is not entitled to vote to accept or reject the Plan.

**(2) Treatment.**

On the Distribution Date, Bank of America, as Holder of the Allowed Scopac Loan Claim, shall receive from the Debtors in full satisfaction, release and discharge of and in exchange for such Claim, payment (i) Cash in an amount equal to the unpaid portion of such Scopac Loan Claim plus accrued but unpaid interest, fees and other expenses, at the applicable non-default rate of interest under the Scopac Loan, or (ii) such other treatment that the Plan Proponents or the Reorganized Entities and such Holder shall have agreed upon in writing; *provided, however*, that such agreed-upon treatment shall not be more favorable than the treatment provided in subsection (i).

(f) **Treatment of Class 6 - Scopac Timber Note Secured Claims.**

(1) **Impairment and Voting.**

Class 6 is impaired by the Plan. Each Holder of an Allowed Scopac Timber Note Secured Claim as of the Record Date is entitled to vote to accept or reject the Plan.

(2) **Treatment.**

To the extent that Class 6 does not make the election pursuant to section 1111(b)(1)(A)(i) of the Bankruptcy Code, on the Distribution Date, in full satisfaction, release and discharge of and in exchange for such Claims:

(a) The Plan Proponents shall contribute \$225 million in Cash to Newco. Newco shall pay or cause to be paid to the Pre-petition Indenture Trustee, for Pro Rata Distribution to Holders of Scopac Timber Note Secured Claims as of the Record Date, Cash in the amount of \$175 million; and

(b) Newco shall issue or cause to be issued to the Pre-petition Indenture Trustee, for Pro Rata Distribution to Holders of Scopac Timber Note Secured Claims as of the Record Date, the New Timber Notes in the principal amount of \$325 million pursuant to the New Timber Notes Indenture and any related agreements as shall be set forth in the Plan Supplement.

(c) ***Principal Terms of the New Timber Notes.*** The terms and conditions for the New Timber Notes and the New Timber Notes Indenture shall be included in the Plan Supplement and shall include the following principal terms and conditions:

(i) ***Transferability.*** The New Timber Notes shall be tradable as set forth in the New Timber Notes Indenture.

(ii) ***Principal Amount.*** The New Timber Notes shall be in the aggregate original principal amount of \$325 million.

(iii) ***Maturity.*** The New Timber Notes shall be due and payable in full on the first Business Day following the thirty-fifth anniversary of the Effective Date.

(iv) ***Interest.*** The New Timber Notes shall accrue interest on the principal balance (including any interest capitalized to the principal balance as provided herein), less any principal payments, at 5.5% per annum from the Effective Date through the final maturity date.

(v) ***Interest Payments.*** All interest on the New Timber Notes shall be paid in Cash semi-annually in arrears, commencing

on the first Semi-Annual Payment Date following the three-month anniversary of the Effective Date; *provided, however*, that during the first 24 months following the Effective Date: (i) 2.75% of accrued interest on the New Timber Notes shall be capitalized and added to the principal amount of the New Timber Notes on a semi-annual basis, in arrears; and (ii) 2.75% of accrued interest on the New Timber Notes shall be paid in Cash semi-annually in arrears, on each Semi-Annual Payment Date.

(vi) ***Amortization Payments.*** Commencing on the first Semi-Annual Payment Date following the fifteenth-year anniversary of the Effective Date, semi-annual payments shall be made on the outstanding principal balance of the New Timber Notes in an amount (inclusive of accrued interest on the principal amount prepaid) equal to \$4.0625 million less any principal payments made since the last Semi-Annual Payment Date. Except as set forth above, no principal payments shall be due prior to the final maturity date of the New Timber Notes.

(vii) ***Asset Sales.*** Proceeds of assets sales by Newco (i) of up to \$50 million on a cumulative basis shall be retained in their entirety by Newco, and (ii) equal to and in excess of \$50 million on a cumulative basis shall be split 50% to pay down the New Timber Notes and 50% to Newco.

(viii) ***Call Rights.*** At any time while the New Timber Notes remain outstanding, Newco shall have the right, in its sole and absolute discretion, to prepay or repay in whole or in part the obligations under the New Timber Notes by paying the sum of the outstanding principal amount being prepaid or repaid, plus accrued but unpaid interest as of the date of such payment.

(ix) ***Security.*** The New Timber Notes shall be secured in the same collateral as the Scopac Timber Notes.

(x) ***Governing Law.*** The New Timber Notes shall be governed by the laws of the State of New York.

**(3) 1111(b) Treatment.**

To the extent that Class 6 makes the election pursuant to section 1111(b)(1)(A)(i) of the Bankruptcy Code, on the Distribution Date, in full satisfaction, release and discharge of and in exchange for such Claims:

(a) The Plan Proponents shall contribute [\$75] million in Cash to Newco to fund various Claims associated with the Reorganization Cases, ordinary working capital, capital investment in Mill and an interest reserve; and

(b) Newco shall issue or cause to be issued to the Pre-petition Indenture Trustee, for Pro Rata Distribution to Holders of Scopac Timber Note Secured Claims as of the Record Date, the Series A New Timber Notes in the principal amount of \$800 million pursuant to the Series A New Timber Notes Indenture and any related agreements as shall be set forth in the Plan Supplement.

(c) ***Principal Terms of the Series A New Timber Notes and Series B New Timber Notes.*** The terms and conditions for the Series A New Timber Notes, the Series A New Timber Notes Indenture and the Series B New Timber Notes and the Series B New Timber Notes Indenture shall be included in the Plan Supplement and shall include the following principal terms and conditions:

(i) ***Transferability.*** The Series A New Timber Notes and Series B New Timber Notes shall be tradable as set forth in the Series A New Timber Notes Indenture and Series B New Timber Notes Indenture, respectively.

(ii) ***Principal Amount.*** The Series A New Timber Notes shall be in the aggregate original principal amount of \$800 million.

(iii) ***Maturity.*** The Series A New Timber Notes and Series B New Timber Notes shall be due and payable in full on the first Business Day following the twenty-fifth anniversary of the Effective Date, unless Newco voluntarily elects to prepay them sooner.

(iv) ***Interest.*** The Series A New Timber Notes shall accrue interest on the principal balance (including any interest capitalized to the principal balance as provided herein), less any principal payments, at 2.75% per annum from the Effective Date through the final maturity date. Series B New Timber Notes shall accrue interest on the principal balance (including any interest capitalized to the principal balance as provided herein), less any principal payments, at 7% per annum from the date of issuance until the twenty-fifth anniversary following the Effective Date.

(v) ***Interest Payments.*** Commencing on the first Semi-Annual Payment Date following the three-month anniversary of the Effective Date:

(1) 1.75% of accrued interest on the Series A New Timber Notes shall be paid in Cash semi-annually in arrears; provided, however, that during the first ten (10) years following the Effective Date, Newco shall have the option of deferring the Cash payment of the 1.75% annual interest rate on no more than ten (10) of the semi-annual interest payment dates in exchange for issuing

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additional Series B New Timber Notes in a like amount of the interest deferred; and

(2) 1% of accrued interest on the Series A New Timber Notes shall be deferred in exchange for issuing additional Series A New Timber Notes semi-annually in arrears in a like amount of the interest deferred.

(vi) *Amortization Payments.* No principal payments shall be due prior to the final maturity dates of the Series A New Timber Notes and Series B New Timber Notes.

(vii) *Asset Sales.* Proceeds of asset sales by Newco (i) of up to \$50 million on a cumulative basis shall be retained in their entirety by Newco, and (ii) equal to and in excess of \$50 million on a cumulative basis shall be split 50% to pay down the Series A New Timber Notes and Series B New Timber Notes and 50% to Newco.

(viii) *Call Rights.* At any time while any of the Series A New Timber Notes and Series B New Timber Notes remain outstanding, Newco shall have the right, in its sole and absolute discretion, to prepay or repay in whole or in part the obligations under the Series A New Timber Notes and Series B New Timber Notes by paying the sum of the outstanding principal amount being prepaid or repaid, plus accrued but unpaid interest as of the date of such payment.

(ix) *Distributions:* Newco shall have the right to pay tax distributions to its members. Newco shall also have the right to pay other distributions to its members so long as (a) it has paid Cash interest on the Series A New Timber Notes for the immediately preceding three (3) consecutive semi-annual payment dates, and (b) it has a fully funded Cash interest reserve of \$15 million.

(x) *Security.* The Series A New Timber Notes and Series B New Timber Notes shall be secured in the same collateral as the Scopac Timber Notes.

(xi) *Governing Law.* The Series A New Timber Notes and Series B New Timber Notes shall be governed by the laws of the State of New York.

**6.7. Full and Complete Satisfaction.**

The Distributions to the Pre-petition Indenture Trustee for the benefit of Holders of the

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Timber Notes under Article IV of the Plan shall be in full and complete satisfaction, release and discharge of and in exchange for all Allowed Scopac Timber Note Secured Claims. Except for the express obligations created by virtue of the Plan, none of the Debtors, the Plan Proponents and the Reorganized Entities shall have any obligation in respect of the Scopac Timber Note Secured Claims or the Scopac Timber Notes. Without limiting the foregoing, in each case without any further action on the part of the Bankruptcy Court or any Person, including but not limited to the Pre-petition Indenture Trustee, the Holders of Scopac Timber Notes and any governmental agency (x) any and all further Claims for any amounts allegedly owing under the Scopac Timber Notes and the Pre-petition Indenture shall be discharged to the fullest extent permitted under section 1141 of the Bankruptcy Code, (y) the Scopac Timber Notes and Pre-petition Indenture shall be deemed cancelled and of no further force or effect and all obligations thereunder shall be deemed likewise discharged, and (z) the Pre-petition Indenture Trustee shall be discharged of all duties under the Pre-petition Indenture. On the Effective Date, the Holders of Scopac Timber Note Secured Claims shall be deemed to have forever released and discharged the Pre-petition Indenture Trustee under the Pre-petition Indenture.

**6.8. Treatment of Class 7 – Palco Trade Claims.**

**(a) Impairment and Voting.**

Class 7 is impaired by the Plan. Each Holder of an Allowed Palco Trade Claim is entitled to vote to accept or reject the Plan.

**(b) Treatment.**

On the Distribution Date, a Holder of an Allowed Palco Trade Claim shall receive, in full satisfaction, release and discharge of and in exchange for such Claim (plus interest), together with Allowed Scopac Trade Claims, Allowed Palco General Unsecured Claims and Allowed Scopac General Unsecured Claims, its Pro Rata share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.

**6.9. Treatment of Class 8 – Scopac Trade Claims.**

**(a) Impairment and Voting.**

Class 8 is impaired by the Plan. Each Holder of an Allowed Scopac Trade Claim is entitled to vote to accept or reject the Plan.

**(b) Treatment.**

On the Distribution Date, a Holder of an Allowed Scopac Trade Claim shall receive, in full satisfaction, release and discharge of and in exchange for such Claim (plus interest); together with Allowed Palco Trade Claims, Allowed Palco General Unsecured Claims and Allowed Scopac General Unsecured Claims its Pro share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.

**6.10. Treatment of Class 9 - Timber Note Unsecured Claims.**

**(a) Impairment and Voting.**

Class 9 is impaired by the Plan. Each Holder of an Allowed Timber Note Unsecured Claim as of the Record Date is entitled to vote to accept or reject the Plan.

**(b) Treatment.**

Each Holder of a Timber Note Unsecured Claim shall receive from the Litigation Trust, in full satisfaction, release and discharge of and in exchange for such Claim, unless such Holder agrees to accept lesser treatment of such Claim, its applicable Litigation Trust Participation.

**6.11. Treatment of Class 10 - Palco General Unsecured Claims.**

**(a) Impairment and Voting.**

Class 10 is impaired by the Plan. Each Holder of an Allowed Palco General Unsecured Claim as of the Record Date is entitled to vote to accept or reject the Plan.

**(b) Treatment.**

On the Distribution Date, a Holder of an Allowed Palco General Unsecured Claim shall receive, in full satisfaction, release and discharge of and in exchange for such Claim (plus interest), together with Allowed Palco Trade Claims, Allowed Scopac Trade Claims and Allowed Scopac General Unsecured Claims, its Pro share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.

**6.12. Treatment of Class 11 - Scopac General Unsecured Claims.**

**(a) Impairment and Voting.**

Class 11 is impaired by the Plan. Each Holder of an Allowed Scopac General Unsecured Claim as of the Record Date is entitled to vote to accept or reject the Plan.

**(b) Treatment.**

On the Distribution Date, a Holder of an Allowed Scopac General Unsecured Claim shall receive, in full satisfaction, release and discharge of and in exchange for such Claim (plus interest), together with Allowed Palco Trade Claims, Allowed Scopac Trade Claims and Allowed Palco General Unsecured Claims, its Pro share of \$10.6 million plus its applicable Litigation Trust Participation for any remaining amount owed.

**6.13. Treatment of Class 12 - Inter-Debtor Claims.**

**(a) Impairment and Voting.**

Class 12 is impaired by the Plan. Class 12 is deemed to have rejected the Plan, and



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therefore, shall not be entitled to vote to accept or reject the Plan.

**(b) Treatment.**

Inter-Debtor Claims shall be discharged and the Holders of Class 12 Inter-Debtor Claims are entitled to no Distributions under the Plan.

**6.14. Treatment of Class 13 - Non-Debtor Affiliate Claims.**

**(a) Impairment and Voting**

Class 13 is impaired by the Plan. Class 13 is deemed to have rejected the Plan, and therefore, shall not be entitled to vote to accept or reject the Plan.

**(b) Treatment.**

Non-Debtor Affiliate Claims shall be discharged and the Holders of Non-Debtor Affiliate Claims are entitled to no Distributions under the Plan. Pursuant to section 510(a) of the Bankruptcy Code and various loan documents entered into with Marathon, including, without limitation, the Subordinated Intercompany Note dated July 18, 2006, any Claims of Maxxam Group Inc. and its affiliates, Maxxam Inc. and Maxxam Group Holdings Inc., shall be subordinated and shall not be entitled to any Distributions under the Plan.

**6.15. Treatment of Class 14 – Interests in the Debtors.**

**(a) Impairment and Voting.**

Class 14 is impaired under the Plan. The Holders of Class 14 Interests are entitled to no Distributions under the Plan, and all Equity Interests shall be deemed canceled as of the Effective Date. Class 14 is deemed to have rejected the Plan, and therefore, shall not be entitled to vote to accept or reject the Plan.

**(b) Treatment.**

On the Effective Date, all Equity Interests shall be canceled, annulled and extinguished and all other agreements, instruments and documents evidencing the Equity Interests and the rights of the Holders thereof, shall be automatically cancelled and deemed null and void and of no further force and effect (all without further act or action by any Person) and Holders of Equity Interests shall not be entitled to receive or retain any property or interest in property under the Plan on account of such Equity Interests.

**6.16. Claims for Substantial Contribution.**

No Claim for substantial contribution pursuant to section 503(b) of the Bankruptcy Code by the Committee, any present or former members thereof or their respective professionals, representatives and agents shall be allowed against the Debtors or their Estates; *provided, however,* that members for the Committee may assert Claims for the reimbursement of actual, necessary expenses pursuant to section 503(b)(3)(F) of the Bankruptcy Code.

**6.17. Provisions Regarding Voting, Effect Of Rejection By Impaired Classes, And Consequences Of Nonconfirmability.**

**(a) Voting Rights.**

Each Holder of an Allowed Claim or Allowed Interest as of the Voting Deadline in an impaired Class of Claims or Interests that is not deemed to have rejected the Plan shall be entitled to vote separately to accept or reject the Plan as provided in the order entered by the Bankruptcy Court establishing certain procedures with respect to the solicitation and tabulation of votes to accept or reject the Plan.

**(b) Acceptance Requirements.**

An impaired Class of Claims shall have accepted the Plan if votes in favor of the Plan have been cast by at least two-thirds in amount and more than one-half in number of the Allowed Claims in such Class that have voted on the Plan. An impaired Class of Interests shall have accepted the Plan if votes in favor of the Plan have been cast by at least two-thirds in amount of the Interests in such Class that have voted on the Plan.

**(c) Cramdown.**

If all applicable requirements for Confirmation of the Plan are met as set forth in section 1129(a)(1) through (13) of the Bankruptcy Code, except subsection (8) thereof, the Plan shall be treated as a request that the Bankruptcy Court confirm the Plan in accordance with section 1129(b) of the Bankruptcy Code, notwithstanding the failure to satisfy the requirements of section 1129(a)(8), on the basis that the Plan is fair and equitable and does not discriminate unfairly with respect to each Class of Claims that is impaired under, and has not accepted, the Plan.

**(d) Tabulation of the Votes.**

The Plan Proponents shall cause the tabulation of all votes on the Plan for the purpose of determining whether the Plan satisfies sections 1129(a)(8) and/or (10) of the Bankruptcy Code.

**6.18. Executory Contracts And Unexpired Leases**

**(a) Rejection of Contracts and Leases.**

Except as otherwise provided herein or pursuant to the Confirmation Order, as of the Effective Date, all executory contracts and unexpired leases between the Debtors and any Person, including, but not limited to, all Intercompany Contracts, shall be rejected pursuant to section 365(a) of the Bankruptcy Code except for (a) any such contract or lease that has been assumed or rejected or renegotiated and either assumed or rejected on renegotiated terms, pursuant to an order of the Bankruptcy Court entered prior to the Effective Date, or (b) any such contract or lease that is specifically treated otherwise in the Plan. Entry of the Confirmation Order shall constitute approval, pursuant to section 365(a) of the Bankruptcy Code, of the rejection and assumption of executory contracts and unexpired leases provided for herein;

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*provided, however*, that any Environmental Obligation shall be treated as indicated in Section [2.5] of the Plan and any order entered in connection with Confirmation of the Plan shall not constitute a finding that any Environmental Obligation is an executory contract.

### **(b) Assumption of Certain Specified Contracts and Lease.**

Notwithstanding anything to the contrary contained in the Plan, including Section 6.1 of the Plan, a list of Assumed Contracts which shall be deemed assumed pursuant to section 365(a) of the Bankruptcy Code as of the Effective Date shall be provided in the Plan Supplement, together with the Plan Proponents' estimate of the cure costs that would result from such assumption; *provided, however*, that any Environmental Obligation shall be treated as indicated in Section 2.5 of the Plan and any order entered in connection with Confirmation of the Plan shall not constitute a finding that any Environmental Obligation is an executory contract; *provided, further, however*, the Plan Proponents and the Reorganized Entities reserve the right, at any time prior to the Effective Date, to amend the Plan Supplement to: (a) delete any Assumed Contract listed therein, thus providing for its rejection pursuant to the Plan; or (b) add any executory contract or unexpired lease thereto, thus providing for its treatment as an Assumed Contract pursuant to the Plan. The Plan Proponents or the Reorganized Entities, as the case may be, shall provide notice of any such amendment to the Plan Supplement to the parties to the Assumed Contract affected thereby and to the parties on the then applicable service list in the Reorganization Cases. Each Assumed Contract listed in the Plan Supplement shall be assumed only to the extent that any such contract or lease constitutes an executory contract or unexpired lease that is subject to assumption or rejection under section 365 of the Bankruptcy Code. Listing a contract or lease in the Plan Supplement shall not constitute an admission by the Plan Proponents or the Reorganized Entities that such contract or lease constitutes an executory contract or unexpired lease that is subject to assumption or rejection under section 365 of the Bankruptcy Code or that the Plan Proponents or the Reorganized Entities have any liability thereunder.

### **(c) Assumptions and Assignments of Real Property Assumed Contracts.**

Each Real Property Assumed Contract listed in the Plan Supplement shall include a description of any modifications, supplements, restatements or other agreements made directly or indirectly by any agreement, instrument or other document that in any manner affects such contract or lease, irrespective of whether such agreement, instrument or other document is listed in the Plan Supplement, unless such modification, amendment, supplement, restatement or other agreement is rejected pursuant to the Plan.

### **(d) Assignments Related to the Restructuring Transactions.**

As of the effective time of an applicable Restructuring Transaction, any Assumed Contract (including any related agreement) to be held by any surviving, resulting or acquiring corporation in an applicable Restructuring Transaction, shall be deemed assumed by the Debtors and assigned to the applicable Reorganized Entity pursuant to section 365 of the Bankruptcy Code.

**(e) Assumption of Pension Plan.**

As of the Effective Date, the Reorganized Entities shall be deemed to have assumed the Palco Pension Plan pursuant to section 365(a) of the Bankruptcy Code. Upon the Effective Date, the Reorganized Entities shall continue to pay the obligations under the Palco Pension Plan in accordance with applicable law with respect to continued funding of such plans. Nothing in the Plan shall be deemed to discharge, release or relieve any Person or Entity from any current or future liability under applicable law with respect to the Palco Pension Plan. Any and all obligations to participants under the Palco Pension Plan shall be paid in accordance with applicable law.

**(f) Worker's Compensation Programs.**

Upon Confirmation and consummation of the Plan, the Reorganized Entities shall continue any pre-petition workers' compensation programs in accordance with applicable law, and the obligations of the Reorganized Entities under applicable law with respect to continued funding of such programs shall remain unaltered. Nothing in the Plan shall be deemed to discharge, release or relieve the Debtors or the Reorganized Entities, of or from any current or future liability for their workers' compensation programs under applicable law. Any and all obligations under the pre-petition workers' compensation programs shall be paid in accordance with applicable law. The Debtors (and the Reorganized Entities, as applicable, upon the Effective Date of the Plan) shall be responsible for all valid claims for benefits and liabilities under the workers' compensation programs regardless of when the actual injuries occurred.

**(g) Compensation and Benefit Programs.**

Except as otherwise set forth in Sections 6.5 and 6.6 of the Plan, to the extent provided herein or in the Plan Supplement, all employment and severance agreements and policies, and all compensation and benefit plans, policies, and programs of the Debtors applicable to their employees, officers and directors including, without limitation, all savings plans, retirement plans, health care plans, disability plans, severance benefit agreements and plans, incentive plans, deferred compensation plans and life, accidental death and dismemberment insurance plans, shall be treated as executory contracts under the Plan, and on the Effective Date shall be deemed rejected pursuant to the provisions of sections 365 and 1123 of the Bankruptcy Code, except for executory contracts or employee benefit plans specifically assumed pursuant to the Plan or the Plan Supplement.

**(h) Cure of Defaults.**

On the Effective Date, the Reorganized Entities, as the case may be, (a) shall cure or provide adequate assurance that it shall cure any and all undisputed defaults under any Assumed Contract, and (b) compensate or provide adequate assurance that it shall promptly compensate the other parties to such executory contract or unexpired lease for the agreed amount of any actual pecuniary loss to such party resulting from such undisputed default in accordance with section 365(b)(1) of the Bankruptcy Code. In the event that the Reorganized Entities dispute the existence of a default, or the nature, extent or amount of any required cure, adequate assurance or compensation, the obligations of the Reorganized Entities under section 365(b) of the

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Bankruptcy Code shall be determined at the Confirmation Hearing or at any other hearing ordered by the Bankruptcy Court, and any such obligations shall be performed by the Reorganized Entities within thirty days after the Effective Date unless otherwise provided in the Confirmation Order or by other order of the Bankruptcy Court.

**(i) Rejection Claims.**

If the rejection of an executory contract by the Debtors (pursuant to the Plan or otherwise) results in a Claim, then such Claim shall be forever barred and shall not be enforceable against the Debtors and the Reorganized Entities unless a Proof of Claim is filed with the Balloting and Claims Agent and served upon counsel for the Debtors, counsel for the Plan Proponents, counsel for the Reorganized Entities and counsel for the Litigation Trustee no later than thirty (30) days after the earlier of (i) entry of the Confirmation Order, or (ii) entry of an order approving such rejection. Unless otherwise ordered by the Bankruptcy Court, all Claims arising from the rejection of executory contracts and unexpired leases shall be treated, to the extent they are Allowed Claims, as Class 7, 8, 10 and 11 Claims, as appropriate, and shall be forever barred and shall not be enforceable against the Reorganized Entities.

**6.19. Means Of Implementation Of The Plan**

**(a) Summary of Reorganization of the Debtors.**

On or prior to the Effective Date, (a) as set forth in Section 4.6.2.1(a)(i) of the Plan, to the extent that Class 6 does not make the election pursuant to section 1111(b)(1)(A)(i) of the Bankruptcy Code, the Plan Proponents shall contribute \$225 million in Cash to Newco, or (b) as set forth in Section 4.6.2.2(a)(i) of the Plan, to the extent that Class 6 makes the election pursuant to section 1111(b)(1)(A)(i) of the Bankruptcy Code, on the Distribution Date, in full satisfaction, release and discharge of and in exchange for such Claims, the Plan Proponents shall contribute [\$75] million in Cash to Newco. Also on the Effective Date, the Debtors shall be reorganized into two newly formed Reorganized Entities, Newco and Townco, and, except as otherwise set forth herein, all of the Debtors' Assets shall be transferred to these Reorganized Entities free and clear of all Claims, Liens, charges, other encumbrances and Interests. On and after the Effective Date, the Reorganized Entities may operate their businesses, may use, acquire and dispose of property, may retain, compensate and pay any professionals or advisors, and compromise or settle any causes of action, claims or interests without supervision of or approval by the Bankruptcy Court and free and clear of any restrictions of the Bankruptcy Code or the Bankruptcy Rules other than restrictions expressly imposed by the Plan and the Confirmation Order.

**(b) Litigation Trust Assets.**

On the Effective Date, as set forth below, all Litigation Trust Assets of the Debtors shall be transferred by the Debtors to the Litigation Trust free and clear of all Claims, Liens, charges, other encumbrances and Interests.

**(c) Voting by and Distributions to Holders of Claims against the Palco Debtors.**

The Palco Debtors shall be pooled for the purposes of voting, Confirmation and Distribution. A Claim against any one of the Palco Debtors shall be deemed as a Claim against all of the Palco Debtors. No distributions shall be made under the Plan on account of Inter-Debtor Claims among the Debtors and such Claims shall be discharged on the Effective Date in accordance with Section 4.12 of the Plan. With respect to the Palco Debtors, Holders of Allowed Claims in each Class established pursuant to the Plan shall be entitled to their Pro Rata Share of assets available for Distribution to such Class without regard to which Palco Debtor was originally liable for such Claim.

**(d) No distributions for Holders of Certain Claims and Interests.**

No distributions shall be made under the Plan on account of Non-Debtor Affiliate Claims and such claims shall be discharged on the Effective Date in accordance with Section 4.13 of the Plan. No distributions shall be made under the Plan on account of Equity Interests in the Debtors, including, without limitations, those Equity Interests held by other Debtor and Non-Debtor affiliates, in accordance with Section 4.14 of the Plan. All guarantees of the Debtors of the obligations of any other Debtor shall be deemed eliminated so that any claim against any Debtor and any guarantee thereof executed by any other Debtor and any joint or several liability of any of the Debtors shall be deemed to be one obligation of the Debtors.

**(e) Operations of the Reorganized Entities.**

On and after the Effective Date, the Reorganized Entities may operate their businesses, may use, acquire and dispose of property, may retain, compensate and pay any professionals or advisors, and compromise or settle any causes of action, claims or interests without supervision of or approval by the Bankruptcy Court and free and clear of any restrictions of the Bankruptcy Code and the Bankruptcy Rules other than restrictions expressly imposed by the Plan or the Confirmation Order.

**(f) Restructuring Transactions.**

**(1) Authorized Share Capital and Corporate Structure.**

On or as soon as reasonably practicable after the Effective Date, as set forth in Article IX of the Plan, (i) 100% of the Newco equity interests shall, without the need for any further corporate act or other action under any applicable law, regulation, order or rule, be issued and distributed by Newco to the Plan Proponents, [85%] to MRC, and [15%] to Marathon (subject to adjustment); and (ii) 100% of the Townco equity interests shall, without the need for any further corporate act or other action under any applicable law, regulation, order or rule, be issued and distributed by Townco to Marathon.

**(2) Transfer of Assets.**

Except as otherwise set forth in the Plan, on the Effective Date, the Debtors shall transfer all Assets of the Estates and Interests in the Estates, to the fullest extent of sections 541 and

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1123(a)(5)(B) of the Bankruptcy Code (including any stock of subsidiaries), and any and all other rights and Assets of the Debtors of every kind and nature to the Reorganized Entities and the Litigation Trust, as applicable, free and clear of all Liens, Claims and Interests other than (i) those Liens, Claims and Interests retained or created pursuant to the Plan or any document entered into in connection with the transactions described in the Plan, and (ii) Liens that have arisen subsequent to the Petition Date on account of taxes that arose subsequent to the Petition Date. The transfer and assignment of any Assets of the Debtors shall be, to the fullest extent permitted by law, exempt from all stamp taxes and similar taxes within the meaning of section 1146(c) of the Bankruptcy Code. Specifically,

- (1) Any and all of the Assets of the Mill and Scopac, and any and all Assets of the Debtors currently associated with or anticipated to be associated with the Mill and Scopac, and any other Assets of the Debtors, other than those being transferred to Townco or transferred to the Litigation Trust, shall be transferred by the Debtors to Newco;
  - (2) Any and all of the Assets of the Debtors currently associated with or anticipated to be associated with the Scotia, including, without limitation, the power plant and the Britt mill in Arcata, California, shall be transferred by the Debtors to Townco;
  - (3) Any Litigation Trust Assets of the Debtors shall be transferred by the Debtors to the Litigation Trust; and
  - (4) Cash in an amount equal to the unpaid portion of the Allowed Class 5 Scopac Loan Claim plus accrued but unpaid interest shall be transferred from the SAR Account by the Debtors to the Holder of the Allowed Class 5 Scopac Loan Claim. Any remaining amount held in the SAR Account shall be transferred by the Debtors to Newco. Any remaining amount owed in respect of the Allowed Class 5 Scopac Loan Claim shall be paid by Newco.
- (g) **Cancellation of Notes, Instruments, and Interests.**

On the Effective Date, and after giving effect to the Distributions to be made on the Effective Date hereunder, (i) all existing securities, equity interests, notes, bonds, indentures, and other instruments or documents evidencing or creating any indebtedness, equity interest or obligation, and all Liens, charges, encumbrances and rights related to the foregoing (except as same relates to the Palco DIP Loan), including but not limited to the Palco Term Loan Agreement, the Scopac Timber Notes, the Pre-petition Indenture, the Scopac Loan Agreement and all Equity Interests, shall, if not terminated, canceled, annulled or extinguished by another provision of the Plan, be fully and finally terminated, cancelled, annulled and extinguished and deemed null and void and of no further force and effect and all obligations thereunder shall be deemed likewise discharged (all without further act or action by any Person) and none of the Debtors, the Plan Proponents and the Reorganized Entities shall have any obligation in respect of same, and (ii) the Pre-petition Indenture Trustee shall be discharged of all duties under the Pre-petition Indenture. Notwithstanding the foregoing and anything in the Plan to the contrary, the Pre-petition Indenture shall continue in effect solely for the purposes of allowing the Pre-petition

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Indenture Trustee to make Distributions to Holders of Allowed Scopac Timber Note Claims pursuant to the Plan.

**(h) Certificates of Formation and Organizational Documents of Reorganized Entities.**

As of the Effective Date, the certificates of formation and limited liability company operating agreements of each of the Reorganized Entities (or comparable organizational documents) shall be substantially in the form set forth in the Plan Supplement and shall, among other things, (i) prohibit the issuance of non-voting equity securities to the extent required by section 1123(a) of the Bankruptcy Code and (ii) authorize the issuance of equity interests in amounts not less than the amounts necessary to permit the distributions thereof required or contemplated by the Plan. After the Effective Date, the Reorganized Entities may amend and restate their certificates of formation and limited liability company operating agreements as permitted by applicable law or pursuant to such certificates of formation and limited liability company operating agreements.

**(i) Additional Transactions.**

The Plan Proponents and the Reorganized Entities reserve the right to undertake transactions as may be necessary or appropriate under the circumstances. Such transactions may include one or more mergers, sales, consolidations, restructurings, acquisitions, dispositions, liquidations or dissolutions, as may be determined by the Plan Proponents or the Reorganized Entities. The actions to effect these Restructuring Transactions may include: (a) the execution and delivery of appropriate agreements or other documents of merger, sale, consolidation, restructuring, disposition, liquidation or dissolution containing terms that are consistent with the terms of the Plan and that satisfy the applicable requirements of applicable state law and such other terms to which the applicable entities may agree; (b) the execution and delivery of appropriate instruments of transfer, assignment, assumption or delegation of any asset, property, right, liability, duty or obligation on terms consistent with the terms of the Plan and having such other terms to which the applicable entities may agree; (c) the filing of appropriate certificates or articles of merger, consolidation, incorporation, formation or dissolution pursuant to applicable state law; and (d) all other actions that the applicable entities determine to be necessary or appropriate, including making filings or recordings that may be required by applicable state law.

**(j) Post-Effective Date Management of the Reorganized Entities.**

Except as expressly provided in the Plan and the certificates of formation and limited liability company operating agreements of the Reorganized Entities, which certificates may be amended from time to time, the operation, management and control of the Reorganized Entities shall be the general responsibility of their boards of directors or managers and senior officers, which shall thereafter have the responsibility for the management, control and operation of the Reorganized Entities, respectively.

**(k) Directors and Officers of the Reorganized Entities.**

On and after the Effective Date, the business and affairs of the Reorganized Entities shall



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be managed by the officers and directors or managers, as the case may be, identified in this Disclosure Statement, as supplemented or otherwise modified by the Plan Supplement. Biographical information regarding these proposed officers, directors, and managers shall be set forth in this Disclosure Statement, as supplemented or otherwise modified by the Plan Supplement. A schedule of the annual compensation to be paid to persons serving as executives, officers and directors or managers as of the Effective Date shall be set forth in the Plan Supplement.

**(l) New Employment, Retirement, Indemnification and Other Related Agreements.**

As of the Effective Date, the Reorganized Entities, as the case may be, shall have the authority, without the need for any approval by the Bankruptcy Court, as determined by their respective governing Persons or Entities, (i) to maintain, amend or revise existing employment, retirement, welfare, incentive, severance, indemnification and other agreements with its active and retired directors or managers, officers and employees, subject to the terms and conditions of any such agreement, and (ii) to enter into new employment, retirement, welfare, incentive, severance, indemnification and other agreements for active and retired employees.

**(m) Exit Financing.**

On the Effective Date, without the requirement of further action, the Reorganized Entities shall be authorized and directed to execute and deliver those documents necessary or appropriate to obtain the Exit Financing, including without limitation, any documents required in connection with the creation or perfection of the Liens on the collateral for the Exit Financing. The maximum amount of Exit Financing with respect to Newco shall be \$50 million or as otherwise permitted under the Pre-petition Indenture for the Timber Notes, secured by the Timberland Assets of Newco. The form of any such documents shall be included in the Plan Supplement. Confirmation of the Plan shall constitute an approval of the transactions contemplated hereby and all the actions to be taken, undertakings to be made and obligation to be incurred by the Reorganized Entities, as the case may be, in connection therewith, including the issuance by Newco to Marathon (and the retention by Marathon) of a promissory note in the aggregate principal amount of \$40 million secured by Liens on the Mill Working Capital. The Exit Financing and or the Reorganized Entities' Cash balances and operations, may be used for any purpose permitted by the Exit Financing, including the funding of obligations under the Plan, such as the payment of Administrative Expense Claims and the satisfaction of ongoing working capital requirements. Cash payments to be made pursuant to the Plan shall be made by the Reorganized Entities, and the Reorganized Entities shall be entitled to transfer funds between and among themselves as they deem to be necessary or appropriate to enable the Reorganized Entities to satisfy their obligations under the Plan. Any intercompany claims resulting from such transfers shall be accounted for and settled in accordance with the methodology determined by the Reorganized Entities in their sole discretion.

**(n) Dissolution of Corporate Entities.**

As soon as practicable after the Effective Date, the Reorganized Entities may take all

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actions necessary or appropriate to effect the dissolution of each of the Debtors under the appropriate state laws or take such other actions as the Reorganized Entities deem appropriate to provide for the revocation of the corporate charter for each of the Debtors.

### **(o) Corporate and LLC Action.**

Upon entry of the Confirmation Order, the transfers and dissolutions contemplated by the Plan shall be deemed authorized and approved in all respects. On the Effective Date, the matters provided under the Plan involving the corporate structures of the Debtors and the Reorganized Entities shall be deemed to have occurred and shall be in effect from and after the Effective Date pursuant to applicable state laws without any requirement of further action by the stockholders or directors of the Debtors or the Reorganized Entities. On the Effective Date, the Litigation Trustee shall be authorized and directed to take all necessary and appropriate actions to effectuate the transactions contemplated by the Litigation Trust Agreement, Plan and other Plan Documents.

### **(p) Authorization to Implement the Plan.**

The entry of the Confirmation Order shall constitute authorization for the Debtors, the Plan Proponents, the Reorganized Entities and the Litigation Trustee to take or cause to be taken all corporate and limited liability company actions necessary or appropriate to implement all provisions of, and to consummate the Plan and the Plan Documents prior to, on and after the Effective Date and all such actions taken or caused to be taken for which Bankruptcy Court authorization is required shall be deemed to have been authorized by the Bankruptcy Court without further act or action under any applicable law, order, rule or regulation, except as otherwise expressly set forth in the Plan.

### **(q) Effectuating Documents and Further Transactions.**

Each of the Debtors, the Plan Proponents, the Reorganized Entities and the Litigation Trustee, as the case may be, is authorized and directed to execute, deliver, file or record such contracts, instruments, releases and other agreements or documents and take such actions as may be necessary or appropriate to effectuate, implement and further evidence the terms and conditions of the Plan Documents.

### **(r) Compliance With Environmental Laws.**

Under the Plan, the Debtors, the Plan Proponents and the Reorganized Entities, as the case may be, shall comply, complete, perform, satisfy and/or provide for satisfaction or completion of any current, ongoing, executory, and future regulatory or statutory obligations which arise or result from, or may arise or result from, the Environmental Obligations.

The Plan is specifically conceived and shall be implemented in a manner which complies with the California state and federal ITPs and consistency determinations under CESA, including the associated HCP and IA, as well as AB 1986, including the Agreement Relating to Enforcement of AB 1986 and the associated, recorded CC&Rs.

**6.20. Establishment Of Litigation Trust And Designation Of Litigation Trustee.**

**(a) Establishment of Litigation Trust.**

On the Effective Date, the Reorganized Entities shall take any and all such actions as may be necessary or appropriate to establish the Litigation Trust, including the execution and delivery of the Litigation Trust Agreement, in substantially the form provided in the Plan Supplement; *provided, however*, for avoidance of doubt, Litigation Trust Assets do not include rights to setoff under section 553 of the Bankruptcy Code; *provided, further, however*, the following Causes of Action shall not be transferred to the Litigation Trust: (i) Causes of Action against Debtor, Plan Proponent (in any capacity, including without limitation, Marathon, as lender to the Palco Debtors), Reorganized Entity and the Holder of the Class 5 Scopac Loan Claim; (ii) Avoidance Actions under section 547(b)(4)(a) of the Bankruptcy Code (i.e., ninety (90) day preference actions), with respect to trade creditors that (x) supply the Reorganized Entities in the ordinary course of their business with goods and services, and (y) are identified in writing by the Reorganized Entities to the Litigation Trustee within ten (10) Business Days after the Litigation Trustee submits a written list of potential defendants to the Reorganized Entities; (iii) Causes of Action with respect to accounts receivables, tax refunds, tax rebates and any other amounts owed to the Debtors or Reorganized Entities by account debtors; and (iv) Causes of Action with respect to Environmental Obligations .

The Litigation Trust may also be known as the "[TBD] Litigation Trust" but shall not be referred to as any of the following: "Scotia Development"; "Pacific Lumber"; "Britt Lumber"; "Salmon Creek"; "Scotia Inn"; "Scotia Pacific"; "Palco"; or "Scopac".

**(b) Federal Income Tax Treatment.**

For federal income tax purposes, the beneficiaries of the Litigation Trust shall be treated as the grantors of the Litigation Trust and deemed to be the owners of the assets of the Litigation Trust, and the Reorganized Entities shall treat the transfer of the assets of the Debtors to the Litigation Trust as a deemed transfer to such beneficiaries followed by a deemed transfer by such beneficiaries back to the Litigation Trust.

**(c) Purpose of Litigation Trust.**

The Litigation Trust shall be established for the purposes liquidating and Distributing the Litigation Trust Assets of the Litigation Trust to the Holders of Allowed Classes 7, 8, 9 10, and 11 and paying Statutory Fees as set forth in the Plan. The Funding Amount shall not be considered an asset of the Litigation Trust for Distribution to Holders of Allowed Claims for Classes 7, 8, 9, 10 and 11. The Litigation Trustee shall be responsible for prosecuting, settling, resolving or abandoning all Litigation Trust Assets. Other rights and duties of the Litigation Trustee and the beneficiaries shall be as set forth in the Litigation Trust Agreement. The Reorganized Entities shall provide the Litigation Trustee with reasonable access to their books, records, documents and personnel for investigation and prosecution of the Litigation Trust Assets and for the making of Distributions, at the expense of the Litigation Trust.

**(d) Powers and Obligations of Litigation Trust.**

In addition to all powers enumerated in the Plan, in the Litigation Trust Agreement and in the Confirmation Order, from and after the Effective Date, the Litigation Trust shall succeed to all of the rights of the Debtors necessary for prosecuting, settling, resolving or abandoning all Litigation Trust Assets. As of the Effective Date, the Litigation Trust shall be responsible for performing the obligations, enforcing the rights and exercising the remedies of the Debtors with respect to any claim or interest of the Debtors or the Estates in accordance with section 1123(b)(3)(B) of the Bankruptcy Code, for making distributions to Holders of Allowed Claims for Classes 7, 8, 9, 10 and 11, and for settling, resolving and objecting to Claims for Classes 7, 8, 9, 10 and 11 against the Debtors and for the investigation, prosecution and/or settlement of Litigation Trust Assets.

**(e) Litigation Trust Distributions.**

On the Effective Date, each Holder of an Allowed Claim in Classes 7, 8, 9, 10 and 11, shall, by operation of the Plan, (i) become a beneficiary of the Litigation Trust, (ii) be bound by the Litigation Trust Agreement, and (iii) receive its Litigation Trust Participation. The Litigation Trustee shall make distributions to the Holders of Allowed Claims in Classes 7, 8, 9, 10 and 11 as set forth in the Litigation Trust Agreement and the Plan.

**(f) Appointment of the Litigation Trustee.**

Subject to Bankruptcy Court approval, the Committee and the Plan Proponents shall nominate one person to serve as the Litigation Trustee. The identity and resume of the Litigation Trustee shall be filed with the Bankruptcy Court and served on those requesting notice pursuant to Bankruptcy Rule 2002 at least 15 days before the Confirmation Date or such other date fixed by the Bankruptcy Court. The Litigation Trustee shall be the exclusive trustee of the assets of the Litigation Trust for purposes of 31 U.S.C. § 3713(b) and 26 U.S.C. § 6012(b)(3), as well as the appointed representative of the Debtors with respect to the Avoidance Actions and all other Litigation Trust Assets, and net proceeds thereof, pursuant to section 1123(b)(3)(B) of the Bankruptcy Code. The only assets of the Litigation Trust shall be the Litigation Trust Assets and the net proceeds thereof.

**(g) Litigation Trust Board.**

The Committee shall choose three persons to serve, without compensation, as members of the Litigation Trust Board, which shall have the responsibility to review and advise the Litigation Trustee with respect to the liquidation and Distribution of the Litigation Trust Assets in accordance with the Litigation Trust Agreement and the Confirmation Order.

**(h) Litigation Trusts Costs and Expenses.**

The costs and expenses incurred by the Litigation Trust on and after the Effective Date shall be paid in the ordinary course of business from the Litigation Trust.

**(i) Litigation Trust Funding.**

The Litigation Trustee shall satisfy any fees and expenses of the Litigation Trust with Cash proceeds of the Litigation Trust Assets when and to the extent they are realized. The Litigation Trustee, in its discretion, shall hire counsel and such other professionals. On the Effective Date, Newco shall fund or cause to be funded the Funding Amount to the Litigation Trust. Except as set forth in Section 8.9 of the Plan, the Debtors, the Plan Proponents, and the Reorganized Entities shall have no obligation to provide any funds or other property or assets to the Litigation Trust and pay or reimburse any of its expenses.

**(j) Distributions.**

Any recovery by the Litigation Trust on account of the Litigation Trust Assets shall be applied in the following order: (i) first, to pay any unpaid costs and expenses of the Litigation Trust, including without limitation reasonable attorneys' fees and expenses and court costs; (ii) second, to repay the Funding Amount to Newco, together with interest thereon, until the Funding Amount (together with all accrued interest) has been repaid in full; and (iii) third, distributed to Holders of Allowed Claims for Classes 7, 8, 9, 10 and 11 in accordance with the Plan and the Litigation Trust Agreement.

**(k) Resignation, Death or Removal of the Litigation Trustee.**

The Litigation Trustee may be removed by the Litigation Trust Board with the approval of the Bankruptcy Court upon application for good cause shown. In the event of the resignation, removal, death or incapacity of the Litigation Trustee, the Litigation Trust Board shall designate another Person to become Litigation Trustee and thereupon the successor the Litigation Trustee, without any further action, shall become fully vested with all of the rights, powers, duties and obligations of his or her predecessor.

**(l) Termination of the Litigation Trust.**

The duties, responsibilities and powers of the Litigation Trustee, and the Litigation Trust, shall terminate on the earlier of (i) full resolution of all Litigation Trust Assets transferred to the Litigation Trust, Distribution of the Litigation Trust Assets and the net proceeds thereof in accordance with the Plan and the Litigation Trust Agreement, and conclusion of all matters relative to the administration of the Litigation Trust, except for the filing of all final tax returns, (ii) payment in full in Cash of the Allowed Claims of Holders of Allowed Claims for Classes 7, 8, 9, 10 and 11, or (iii) three (3) years from the Effective Date; *provided, however*, subject to approval of the Bankruptcy Court upon a finding for cause shown that an extension is necessary for the purpose of the Litigation Trust, the term of the Litigation Trust may be extended for a finite period based upon the particular circumstances at issue. Each such extension must be approved by the Bankruptcy Court within six (6) months of the beginning of the extended term with written notice thereof to include the Plan Proponents and the Reorganized Entities.

**6.21. Method Of Distributions Under The Plan And Claims Reconciliation.**

**(a) Method of Distributions Under the Plan.**

Distributions under the Plan shall be made in accordance with the following:

**(1) Distributions for Claims Allowed as of the Effective Date.**

Other than as set forth herein, all Distributions under the Plan to be made on the Effective Date to Holders of Claims that are Allowed as of the Effective Date shall be deemed made on the Effective Date if made on the Effective Date or as promptly thereafter as practicable, but in any event no later than: (a) 60 days after the Effective Date, or (b) such later date when the applicable conditions of Section 6.8 (Cure of Defaults) and Section 9.1.6 (Unclaimed/Undeliverable Distributions) of the Plan are satisfied; *provided, however*, that (i) transfers of the Debtors' assets to the Reorganized Entities and Distributions of equity interests by the Reorganized Entities shall be made on the Effective Date; (ii) Distributions to the Holders of Allowed Class 6 Claims shall be made in accordance with the provisions of the New Timber Notes Indenture and (iii) Distribution to Holders of Allowed Claims for Classes 7, 8, 9, 10 and 11 shall be governed by the Litigation Trust Agreement.

**(2) Distributions for Claims Allowed after the Effective Date.**

On each Quarterly Payment Date, the Litigation Trustee or the Reorganized Entities, as the case may be, shall make all distributions that become deliverable to Holders of Allowed Claims during the preceding calendar quarter.

**(3) Delivery of Distributions.**

All Distributions to be made under the Plan shall be made to Holders of Allowed Claims (a) if any such Holder has filed a Proof of Claim, at the address of such Holder as set forth in the Proof of Claim, or at the addresses set forth in any written certification of address change delivered to the Disbursing Agent after the date of filing of such Proof of Claim, or (b) if any such Holder has not filed a Proof of Claim, at the last known address of such Holder as set forth in the Debtors' Schedules or Debtors' books and records.

**(4) Timing of Distributions.**

Any payment or other Distribution required to be made under the Plan on a day other than a Business Day shall be due on the next succeeding Business Day. All payments or Distributions due on the Effective Date shall be made thereon or as soon as practicable thereafter but in no event later than ten calendar days after the Effective Date. Any payment of Cash made pursuant to the Plan shall be deemed made when such payment by check or wire transfer is transmitted.

**(5) Minimum Cash Distributions.**

No Cash payment less than fifty dollars shall be made to any Holder of a Claim unless a request therefor is made in writing to the Reorganized Entities and the Litigation Trustee, as the case may be.

**(6) Unclaimed/Undeliverable Distributions.**

If any Cash or other Distribution pursuant to the Plan to any Holder of an Allowed Claim is returned as undeliverable, no further Distributions to such Holder shall be made until such time as the Reorganized Entities or the Litigation Trustee, as the case may be, is notified by written certification of such Holder's then-current address, at which time Distributions to such Holder shall be made without interest.

**(7) Failure to Claim Undeliverable Distributions.**

Any Holder of an Allowed Claim that does not assert a claim pursuant to the Plan for an undeliverable Distribution within one year after the Distribution was initially attempted shall have its claim for such undeliverable Distribution discharged and such Distributions shall be deemed to be unclaimed property under section 347(b) of the Bankruptcy Code. After such date, all Cash or other Distribution shall be forfeited and transferred to or retained by the Reorganized Entities or the Litigation Trustee, as the case may be, that attempted such payment free from any restrictions thereon, and the claim of any Holder to such Cash or other Distribution pursuant to the Plan shall be discharged and forever barred. Any Holder shall be forever barred from asserting any such claim against the Reorganized Entities. Nothing contained in the Plan shall require the Reorganized Entities or the Litigation Trustee to attempt to locate any Holder of an Allowed Claim. Unclaimed and undeliverable Distributions from the Litigation Trust to the Holders of Litigation Trust participations shall be governed by the Litigation Trust Agreement.

**(8) Withholding and Reporting Requirements.**

In connection with the Plan, the Debtors and the Reorganized Entities, as applicable, shall comply with all withholding and reporting requirements imposed by federal, state, local, and foreign taxing authorities and all Distributions hereunder shall be subject to such withholding and reporting requirements. Notwithstanding the above, each Holder of an Allowed Claim that is to receive a Distribution shall have the sole and exclusive responsibility for the satisfaction and payment of any tax obligations imposed by any government unit, including income, withholding and other tax obligations, on account of such Distribution. The Reorganized Entities have the right, but not the obligation, to not make a Distribution until such Holder has made arrangements satisfactory to the Reorganized Entities for payment of any such tax obligations.

**(9) Setoff Rights.**

The Reorganized Entities and the Litigation Trustee, as applicable, may, but shall not be required to, setoff against or recoup from the Holder of any Allowed Claim on which payments or other Distributions are to be made hereunder, claims of any nature that the Debtors, the Reorganized Entities or the Litigation Trust, as the case may be, may have against the Holder of

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such Allowed Claim. However, neither the failure to do so, nor the allowance of any Claim under the Plan, shall constitute a waiver or release of any such claim, right of setoff or right of recoupment against the Holder of such Allowed Claim.

**(b) Claims Administration Responsibility.**

**(1) Right to Object to Claims.**

The Debtors and the Reorganized Entities, as the case may be, have the responsibility and authority for administering, disputing, objecting to, compromising and settling or otherwise resolving and finalizing Distributions (if any) with respect to all Claims; *provided, however*, with respect to Class 7, 8, 9, 10 and 11 Claims, the Litigation Trustee as set forth in the Litigation Trust Agreement shall have the responsibility and authority for administering, disputing, objecting to, compromising and settling or otherwise resolving and finalizing Distributions (if any) with respect to such Claims. The Reorganized Entities, as the case may be, also shall have the right to litigate any Claims in any other court of competent jurisdiction, subject to any applicable state or federal statute of limitations. In addition, the Plan Proponents, the Reorganized Entities and the Litigation Trustee, as applicable, may, at any time, request that the Bankruptcy Court estimate any contingent or unliquidated Claim pursuant to section 502(c) of the Bankruptcy Code regardless of whether the Debtors have previously objected to such Claim.

**(2) Claims Objection Deadline.**

The Debtors, the Reorganized Entities and the Litigation Trustee, as the case may be, shall have until the date that is 180 days after the Effective Date to bring any objections to Claims; *provided, however*, that such deadline may be extended by the Bankruptcy Court upon motion of the Debtors, the Reorganized Entities or the Litigation Trustee, as the case may be, without notice or a hearing.

**(3) Compromise and Settlements.**

From and after the Effective Date, and without any further approval by the Bankruptcy Court, the Reorganized Entities and the Litigation Trustee, as applicable, may compromise and settle any Claims and Causes of Action against the Debtors or their respective Estates.

**(c) Process for Disputing Claims.**

**(1) Disallowance of Improperly Filed Claims.**

Any Administrative Expense Claim or other Claim for which the filing of a motion for allowance is required shall be disallowed if such filing is not timely and properly made, subject to the right of the Claimant to seek permission under applicable law to file a late Claim.



**(2) No Distributions Pending Allowance.**

If a Claim or any portion of a Claim is disputed, no payment or Distribution shall be made on account of the disputed portion of such Claim (or the entire Claim, if the entire Claim is disputed), unless such Disputed Claim or portion thereof becomes an Allowed Claim.

**(3) Distributions After Allowance.**

On each Quarterly Distribution Date after a Disputed Claim becomes an Allowed Claim, the Reorganized Entities, as applicable, shall distribute on the next succeeding Distribution Date to the Holder of such Allowed Claim any Cash other property that would have been distributed to the Holder of such Allowed Claim on the dates Distributions were previously made to Holders of other Allowed Claims had such Claim been an Allowed Claim on such dates; *provided, however,* Distributions from the Litigation Trust on account of any Disputed Claim that has become an Allowed Claim shall be governed by the Litigation Trust Agreement.

**6.22. Effect Of Confirmation Of Plan**

**(a) Discharge.**

**(1) Discharge of Claims Against the Debtors and the Reorganized Entities.**

*Except as otherwise expressly provided in the Plan (i.e. Section 2.5) or the Confirmation Order, the Confirmation of the Plan shall as of the Effective Date: (i) discharge the Debtors, the Reorganized Entities and any of their Assets from all Claims demands, liabilities, other debts and Interests that arose on or before the Effective Date, including, without limitation, all debts of the kind specified in sections 502(g), 502(h), or 502(i) of the Bankruptcy Code, whether or not (A) a Proof of Claim based on such debt is filed or deemed filed pursuant to section 501 of the Bankruptcy Code, (B) a Claim based on such debt is Allowed pursuant to section 502 of the Bankruptcy Code, or (C) the Holder of a Claim based on such debt has accepted the Plan; and (ii) preclude all Persons from asserting against the Debtors, the Reorganized Entities or any of their Assets any other or further Claims or Interests based upon any act or omission, transaction or other activity of any kind or nature that occurred prior to the Effective Date, all pursuant to sections 524 and 1141 of the Bankruptcy Code. The discharge provided in this provision shall void any judgment obtained against any of the Debtors at any time, to the extent that such judgment relates to a discharged Claim or cancelled Interest.*

**(2) Injunction Related to the Discharge**

*Except as otherwise provided in the Plan (i.e. Section 2.5) or the Confirmation Order, all entities that have held, currently hold or may hold Claims or other debts or liabilities against the Debtors or an Interest or other right of an equity security Holder in any or all of the Debtors that are discharged pursuant to the terms of the Plan are permanently enjoined, on and after the Effective Date, from taking any of the following actions on account of any such Claims, debts, liabilities or Interests or rights: (i) commencing or continuing in any manner any action or other proceeding of any kind with respect to any such Claim debt, liability, Interest or right other than*

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*to enforce any right to a Distribution pursuant to the Plan; (ii) enforcing, attaching, collecting or recovering in any manner any judgment, award decree or order against the Debtors, the Reorganized Entities or any of their Assets on account of any such Claim debt, liability, Interest or right; (iii) creating perfecting or enforcing any Lien or encumbrance against the Debtors, the Reorganized Entities or any of their Assets on account of any such Claim debt liability, Interest or right; (iv) asserting any right of setoff subrogation or recoupment of any kind against any debt, liability or obligation due to the Debtors, the Reorganized Entities or any of their Assets on account of any such Claim debt, liability, Interest or right; and (v) commencing or continuing any action in any manner, in any place that does not comply with or is inconsistent with the provisions of the Plan or the Confirmation Order. Such injunction shall extend to any successor of the Debtors, the Reorganized Entities and any of their Assets. Any entity injured by a willful violation of such injunction shall recover actual damages, including costs and attorneys' and experts' fees and disbursements, and, in appropriate circumstances, may recover punitive damages from the willful violator.*

**(b) Releases.**

**(1) Releases by the Debtors.**

*As of the Effective Date, for good and valuable consideration the adequacy of which is hereby confirmed, the Debtors in their individual capacity and as debtors-in-possession shall be deemed to release and forever waive and discharge all Claims obligations, suits judgments, damage demands, debts, rights, Causes of Action and liabilities whether liquidated or unliquidated, fixed or contingent, matured or unmatured, known or unknown foreseen or unforeseen, then existing or thereafter arising, in law equity or otherwise that are based in whole or part on any act, omission, transaction event or other occurrence taking place on or prior to the Effective Date (including prior to the Petition Date) in any way relating to the Debtors, the Reorganization Cases, the Plan or the Disclosure Statement and that could have been asserted by or on behalf of the Debtors or their Estates at any time up to immediately prior to the Effective Date against the Released Parties.*

**(2) Certain Waivers.**

*Although the Debtors and the Plan Proponents do not believe that California law is applicable to the Plan, nevertheless, in an abundance of caution, each Debtor hereby understands and waives the effect of Section 1542 of the California Civil Code to the extent that such section is applicable to the Debtors. Section 1542 of the California Civil Code provides:*

**"§1542. A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM MUST HAVE MATERIALLY AFFECTED HIS SETTLEMENT WITH THE DEBTOR."**

**EACH DEBTOR AGREES TO ASSUME THE RISK OF ANY AND ALL UNKNOWN UNANTICIPATED OR MISUNDERSTOOD DEFENSES CLAIMS CAUSES OF ACTION**

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*CONTRACTS LIABILITIES INDEBTEDNESS AND OBLIGATIONS WHICH ARE RELEASED BY THE PLAN AND EACH DEBTOR HEREBY WAIVES AND RELEASES ALL RIGHTS AND BENEFITS WHICH IT MIGHT OTHERWISE HAVE UNDER THE AFOREMENTIONED SECTION 1542 OF THE CALIFORNIA CIVIL CODE WITH REGARD TO THE RELEASE OF SUCH UNKNOWN UNANTICIPATED OR MISUNDERSTOOD DEFENSES CLAIMS CAUSES OF ACTION CONTRACTS, LIABILITIES, INDEBTEDNESS AND OBLIGATIONS. TO THE EXTENT (IF ANY) ANY OTHER LAWS SIMILAR TO SECTION 1542 OF THE CALIFORNIA CIVIL CODE MAY BE APPLICABLE EACH DEBTOR WAIVES AND RELEASES ANY BENEFIT RIGHT OR DEFENSE WHICH IT MIGHT OTHERWISE HAVE UNDER ANY SUCH LAW WITH REGARD TO THE RELEASE OF UNKNOWN UNANTICIPATED OR MISUNDERSTOOD DEFENSES CLAIMS CAUSES OF ACTION CONTRACTS LIABILITIES INDEBTEDNESS AND OBLIGATIONS.*

**(c) Preservation of Rights of Action by the Debtors and the Reorganized Entities.**

*Except as provided in the Plan or in any contract, instrument, release or other agreement entered into or delivered in connection with the Plan, in accordance with section 1123(b) of the Bankruptcy Code and to the fullest extent possible under applicable law, the Reorganized Entities and the Litigation Trustee, as the case may be, shall retain and may enforce, and shall have the sole right to enforce, any claims demands, rights and Causes of Action that any Debtor or Estate may hold against any Entity. The Reorganized Entities, the Litigation Trustee or their successors, as the case may be, and may pursue such retained claims, demands, rights or Causes of Action, as appropriate, in accordance with the best interests of the Reorganized Entities, the Litigation Trust, or their successors, as the case may be, holding such claims, demands, rights or Causes of Action. Further, the Reorganized Entities, as the case may be, retain their rights to file and pursue, and shall have the sole right to file and pursue any adversary proceedings against any account debtor related to debit balances or deposits owed to any Debtor.*

**(d) Injunction Related to Releases.**

*To the fullest extent allowed by law, and except as otherwise provided in the Plan (i.e. Section 2.5) or the Confirmation Order, all Entities that have held currently hold or may hold claims, obligations suits, judgments damages demands debts, rights, Causes of Action and liabilities that are released pursuant to Section 10.2.1 of the Plan are permanently enjoined, on and after the Effective Date from taking any of the following actions on account of any such claims, obligations, suits, judgments, damages, demands, debts, rights, Causes of Action, and liabilities: (i) commencing or continuing in any manner any action or other proceeding of any kind against a Released Party with respect to any such claims, obligations, suits, judgments, damages, demands, debts, rights, Causes of Action, and liabilities; (ii) enforcing, attaching, collecting or recovering in any manner any judgment, award, decree or order against any Released Party or any of its or their Assets on account of any such claims, obligations, suits, judgments, damages, demands, debts, rights, Causes of Action, and liabilities; (iii) creating, perfecting or enforcing any Lien or encumbrance against any Released Party or any of its or their Assets on account of any such claims, obligations, suits, judgments, damages, demands, debts, rights, Causes of Action, and liabilities; (iv) asserting any right of setoff, subrogation or*

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*recoupment of any kind against any debt liability or obligation due to any Released Party or any of its or their Assets on account of any such claims, obligations, suits, judgments, damages, demands, debts, rights, Causes of Action, and liabilities; and (v) commencing or continuing any action, in any manner, in any place that does not comply with or is inconsistent with the provisions of the Plan or the Confirmation Order. Such injunction shall extend to any successor of any Released Party or any of its or their Assets. Any Entity injured by any willful violation of such injunction shall recover actual damages, including costs and attorneys' and experts' fees and disbursements, and, in appropriate circumstances, may recover punitive damages from the willful violator.*

**(e) Exculpation.**

*The Exculpated Parties shall not be liable, other than for gross negligence or willful misconduct, to any Holder of a Claim or Interest or any other Entity with respect to any action omission, forbearance from action, decision, or exercise of discretion taken at any time prior to the Effective Date in connection with:*

- *the management or operation of the Debtors or the discharge of their duties under the Bankruptcy Code;*
- *the implementation of any of the transactions provided for, or contemplated in, the Plan or the other Plan Documents;*
- *any action taken in connection with either the enforcement of the rights of any Debtor against any Entities or the defense of Claims asserted against any such Debtor with regard to the Reorganization Cases;*
- *any action taken in the negotiation, formulation, development, proposal, solicitation, disclosure, Confirmation, or implementation of the Plan or the other Plan Documents; or*
- *the administration of the Plan or the assets and property to be distributed pursuant to the Plan.*

*In connection with this provision, the Exculpated Parties are entitled to reasonably rely upon the opinions of their respective counsel, accountants, and other experts or professionals and such reliance, if reasonable, shall conclusively establish the absence of gross negligence or willful misconduct; provided, however, that a determination that such reliance is unreasonable shall not, by itself, constitute a determination regarding the existence of willful misconduct or gross negligence.*

*If the Holder of a Claim or Interest or other Entity brings an action, suit or proceeding covered by the relevant Article of the Plan and does not prevail, such Holder or other Entity must pay the reasonable attorneys' fees and costs to the Exculpated Party. Moreover, as a condition to going forward with such action, suit, or proceeding, the Holder of a Claim or Interest or other Entity must, at the outset, provide appropriate proof and assurances of its capacity to pay the Exculpated Party's reasonable attorneys' fees and costs in the event the*

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*Holder or other Entity fails to prevail. The Exculpated Party shall have no obligation to pay, or provide appropriate proof and financial assurance of its capacity to pay, reasonable attorneys' fees and costs in the event that the Holder of a Claim or Interest or other Entity prevails in an such action suit or proceeding against such Exculpated Party.*

*The Plan does not protect the Exculpated Parties from liability for any conduct in violation of the Environmental Obligations. Any such liability shall be determined under non-bankruptcy law in an appropriate forum.*

**(f) No Liability for Solicitation or Participation.**

None of the Plan Proponents, the Reorganized Entities, the Administrative Agent and the lenders under the Term Loan Agreement, dated as of July 18, 2006, the Administrative Agent and the lenders under the Revolving Credit Agreement, dated as of July 18, 2006, and the Administrative Agent and lenders under the Debtor-In-Possession Revolving Credit Agreement dated as of August 6, 2007, nor any of their respective current members, partners, officers, directors, employees, affiliates, agents and advisors (including any attorneys, financial advisors, investment bankers, accountants and other professionals retained by such Persons) shall have or incur any liability to any Holder of any Claim or Interest for any act or omission in connection with, or arising out of the Plan, the Reorganization Cases, the Disclosure Statement, the Palco DIP Loan, the Exit Financing, any agreements relating to the foregoing or with respect to the transactions contemplated hereunder or thereunder, the solicitation of votes for and the pursuit of the Plan, the consummation of the Plan or the administration of the Plan or the property to be distributed under the Plan, including, without limitation, all documents ancillary thereto, all decisions, actions, inactions and alleged negligence or misconduct relating thereto and all pre-petition activities leading to the promulgation and Confirmation of the Plan, except willful misconduct or gross negligence as determined by a Final Order of the Bankruptcy Court. The foregoing parties shall be entitled to rely upon the advice of counsel with respect to their duties and responsibilities under the Plan.

**(g) No Successor Liability.**

Except as otherwise expressly provided herein, none of the Released Parties shall be determined to be successors to any of the Debtors or to any Entity for which the Debtors or the Reorganized Entities may be held legally responsible, by reason of any theory of law or equity, and none can be responsible for any successor or transferee liability of any kind or character. The Released Parties do not agree to perform, pay, or indemnify creditors or otherwise have any responsibilities for any liabilities or obligations of the Debtors or the Reorganized Entities, whether arising before, on, or after the Confirmation Date, except as otherwise expressly provided in the Plan.

**(h) Release of Liens.**

Except as otherwise expressly provided in the Plan or in any contract, instrument, indenture or other agreement or document expressly incorporated by reference in the Plan, the Confirmation Order shall release any and all Liens; *provided, however,* that this provision shall

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not prevent Liens from attaching to the Reorganized Entities' Assets as provided for by the Plan, the Exit Financing or otherwise.

### **(i) Term of Injunctions.**

All injunctions or stays provided in, or in connection with, the Reorganization Cases, whether pursuant to section 105 of the Bankruptcy Code, section 362 of the Bankruptcy Code, or any other provision of the Bankruptcy Code, other applicable law or court order, in effect immediately prior to Confirmation shall remain in full force and effect until such injunctions become effective and shall remain in full force and effect thereafter if so provided in the Plan, the Confirmation Order or by their own terms. In addition, on and after Confirmation Date, the Debtors may seek further orders to preserve the status quo during the time between the Confirmation Date and the Effective Date.

### **(j) Binding Effect.**

The Plan shall be binding upon, and inure to the benefit of, the estates of the Debtors, the Plan Proponents, the Reorganized Entities and all Holders of Claims and Interests, and their respective successors and assigns, whether or not the Claims and Interests of such Holders are impaired under the Plan, whether or not such Holders have accepted the Plan and whether or not the treatment of such Holders Claims and Interests under the Plan provides for any Distribution to such Holder.

### **(k) Dissolution of the Committee.**

The Committee shall be dissolved on the Effective Date and shall not continue to exist thereafter except for the limited purposes of filing any remaining applications for reimbursement of reasonable fees and expenses of Committee Professionals and Committee members, and the Professionals retained by the Committee shall be entitled to reasonable compensation for services performed and reimbursement of reasonable expenses incurred in connection therewith. Upon dissolution of the Committee, the members of the Committee shall be released and discharged of and from all duties, responsibilities and obligations related to and arising from and in connection with the Reorganization Cases.

### **(l) Retention of Professionals after the Effective Date.**

After the Effective Date, no Professional employed pursuant to sections 327 through 331 of the Bankruptcy Code shall be entitled to any compensation without the express written permission of the Plan Proponents and the Reorganized Entities. Upon the Effective Date, the retention of all such Professionals shall be terminated automatically without further Order of the Bankruptcy Court, except for the limited purposes of filing any remaining applications for reimbursement of reasonable fees and expenses. The Reorganized Entities, as the case may be, shall be authorized to employ and compensate professionals in the ordinary course of business and without the need for Bankruptcy Court approval.

**6.23. EFFECTIVENESS OF THE PLAN**

**(a) Conditions Precedent.**

The Plan shall not become effective unless and until the following conditions have been satisfied:

**(b) Conditions to Confirmation.**

**(1) Disclosure Statement.**

The Bankruptcy Court shall have approved a Disclosure Statement with respect to the Plan as containing adequate information within the meaning of section 1125 of the Bankruptcy Code.

**(2) Plan Supplement.**

The Plan Documents to be provided in the Plan Supplement are in a form that is satisfactory to the Plan Proponents; *provided, however*, that the New Timber Notes Indenture shall be in a form that is reasonably satisfactory to the New Indenture Trustee.

**(c) Conditions to Effective Date.**

**(1) Confirmation Order.**

At least ten days shall have passed after the Bankruptcy Court shall have entered the Confirmation Order in form and substance acceptable to the Plan Proponents.

**(2) No Stay of Confirmation.**

There shall not be in force any order, decree or ruling of any court or governmental body having jurisdiction, restraining, enjoining or staying the consummation of, or rendering illegal the transactions contemplated by, the Plan.

**(3) Receipt of Required Authorization.**

All authorizations, consents and regulatory approvals (if any) necessary to effectuate the Plan shall have been obtained.

**(4) Exit Financing.**

The documents evidencing the Exit Financing shall be in form and substance reasonably acceptable to the Plan Proponents and the Exit Lender; and, to the extent any of such documents contemplates execution by one or more persons, any such document shall have been executed and delivered by the respective parties thereto, and all conditions precedent to the effectiveness of each such document shall have been satisfied or waived.

**(5) Required Transactions.**

All transactions required by the Plan have been completed to the satisfaction of the Plan Proponents.

**(d) Effect of Failure of Conditions.**

In the event that the conditions specified in Article 11.1. of the Plan have not been satisfied on or before 120 days after the Confirmation Date, then the Plan Proponents may seek an order from the Bankruptcy Court vacating the Confirmation Order. If the Confirmation Order is vacated: (a) the Plan shall be null and void in all respects; (b) any settlement of Claims or Interests provided for hereby shall be null and void without further order of the Bankruptcy Court; and (c) the time within which the Debtors may assume and assign or reject all executory contracts and unexpired leases shall be extended for a period of sixty (60) days after the date the Confirmation Order is vacated.

**6.24. Retention Of Jurisdiction**

**(a) Bankruptcy Court.**

Pursuant to sections 105(c) and 1142 of the Bankruptcy Code and notwithstanding entry of the Confirmation Order and the occurrence of the Effective Date, the Bankruptcy Court shall retain such jurisdiction over all matters arising out of, and related to, the Reorganization Cases and the Plan to the fullest extent permitted by law, including, among other things, jurisdiction to:

- (1)** allow, disallow, determine, liquidate, classify, estimate or establish the priority or secured or unsecured status of any Claim or Interest, including, without limitation, the resolution of any request for payment of any Administrative Expense Claim or Priority Tax Claim and the resolution of any objections to the allowance or priority of Claims or Interests;
- (2)** hear and rule upon all Causes of Action retained by the Reorganized Entities and the Litigation Trust and commenced and/or pursued by the Debtors, the Reorganized Entities or the Litigation Trust, as the case may be, provided that such Causes of Action are properly before the Bankruptcy Court;
- (3)** resolve any matters related to the rejection, assumption or assumption and assignment of any executory contract or unexpired lease to which any



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Debtor is a party or with respect to which the Debtors may be liable and to hear, determine, and, if necessary, liquidate any Claims arising therefrom;

- (4) ensure that Distributions on Allowed Claims are accomplished pursuant to the provisions of the Plan;
- (5) decide or resolve any motions, adversary proceedings, contested or litigated matters and any other matters and grant or deny any applications involving the Debtors that may be pending on the Effective Date;
- (6) enter such orders as may be necessary or appropriate to implement or consummate the provisions of the Plan and all contracts, instruments, releases and other agreements or documents created in connection with the Plan, the Disclosure Statement or the Confirmation Order;
- (7) resolve any cases, controversies, suits or disputes that may arise in connection with the consummation, interpretation, or enforcement of the Plan or any contract, instrument, release or other agreement or document that is executed or created pursuant to the Plan, or any entity's rights arising from or obligations incurred in connection with the Plan or such documents;
- (8) approve any modification of the Plan before or after the Effective Date pursuant to section 1127 of the Bankruptcy Code or approve any modification of the Disclosure Statement, the Confirmation Order or any contract, instrument, release or other agreement or document created in connection with the Plan, the Disclosure Statement or the Confirmation Order, or remedy any defect or omission or reconcile any inconsistency in any Bankruptcy Court order, the Plan, the Disclosure Statement, the Confirmation Order or any contract, instrument, release or other agreement or document created in connection with the Plan, the Disclosure Statement or the Confirmation Order, in such manner as may be necessary or appropriate to consummate the Plan;
- (9) hear and determine all applications for compensation and reimbursement of expenses of Professionals under the Plan or under sections 330, 331, 363, 503(b), 1103 and 1129(a)(9) of the Bankruptcy Code, which shall be payable by the Debtors only upon allowance thereof pursuant to the order of the Bankruptcy Court;
- (10) issue injunctions, enter and implement other orders, or take such other actions as may be necessary or appropriate to restrain interference by any Entity with consummation of the Plan, implementation or enforcement of the Plan or the Confirmation Order, including designating one or more Persons under Fed. R. Bankr. P. 7070 and F. R. Civ. P. 70;

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- (11) hear and determine matters concerning state, local and federal taxes in accordance with sections 346, 505 and 1146 of the Bankruptcy Code;
- (12) enter and implement such orders as are necessary or appropriate if the Confirmation Order is for any reason or in any respect modified, stayed, reversed, revoked or vacated, or if Distributions pursuant to the Plan are enjoined or stayed;
- (13) determine any other matters that may arise in connection with or relate to the Plan, the Disclosure Statement, the Confirmation Order or any contract, instrument, release, or other agreement, or document created in connection with the Plan, the Disclosure Statement or the Confirmation Order;
- (14) enforce all orders, judgments, injunctions, releases, exculpations, indemnifications and rulings entered in connection with the Reorganization Cases;
- (15) hear and determine all matters related to (i) the property of the Debtors and the Estates from and after the Confirmation Date and (ii) the activities of the Debtors, Newco or Townco; and
- (16) hear and determine such other matters as may be provided in the Confirmation Order or as may be authorized under the Bankruptcy Code.

(b) **Alternative Jurisdiction.**

In the event that the Bankruptcy Court is found to lack jurisdiction to resolve any matter, then such matter may be brought before any court having jurisdiction with regard thereto; *provided, however,* that any party that has filed a Claim or votes to accept the Plan consents to the jurisdiction of the United States District Court for the Southern District of Texas, Corpus Christi Division and to venue in Nueces County, Texas, regardless of whether the Class of which such party is a member votes to accept the Plan.

**6.25. Miscellaneous Provisions.**

(a) **Plan Supplement.**

No later than ten days prior to the Voting Deadline, the Plan Proponents shall file with the Bankruptcy Court in the Plan Supplement such agreements and other documents as may be necessary or appropriate to effectuate and further evidence the terms and conditions of the Plan. Holders of Claims or Interests may obtain a copy of the Plan Supplement upon written request to the Plan Proponents' counsel and such request may be fulfilled by providing an electronic copy of the Plan Supplement by electronic mail or otherwise.

**(b) Authorization of Effectuating Documents and Further Transactions.**

The Debtors' officers are authorized in accordance with their authority under the applicable governing documents and under the supervision of the Plan Proponents, the Reorganized Entities or any of such entities' board of directors or board of managers, as the case may be, to execute, deliver, file, or record such contracts, instruments, releases, indentures and other agreements or documents, and to take such actions as may be necessary or appropriate, to effectuate and further evidence the terms and conditions of the Plan and the debt and equity securities issued pursuant to the Plan.

**(c) Exemption from Transfer Taxes.**

Pursuant to section 1146(c) of the Bankruptcy Code, the issuance, transfer, or exchange of notes or equity securities under the Plan, the creation of any mortgage, deed of trust, Lien, pledge or other security interest, the making or assignment of any lease or sublease, or the making or delivery of any deed or other instrument of transfer under, in furtherance of, or in connection with the Plan, shall not be subject to any stamp, real estate transfer, mortgage recording, or other similar tax.

**(d) Exemption for Registration Requirements.**

Pursuant to section 1145 of the Bankruptcy Code, the offering, issuance and Distribution of any securities contemplated by the Plan shall be exempt from, among other things, the registration requirements of Section 5 of the Securities Act and any state or local law requiring registration prior to the offering, issuance, distribution or sale of securities. In addition, any securities contemplated by the Plan shall be tradable by the recipients thereof, subject to (i) the provisions of section 1145(b)(1) of the Bankruptcy Code; and (ii) the restrictions, if any, on the transferability of such securities and instruments.

**(e) Statutory Fees.**

All fees payable pursuant to section 1930 of title 28 of the United States Code, as determined by the Bankruptcy Court at the Confirmation Hearing, shall be paid by the Debtors on or before the Effective Date, and thereafter by the Litigation Trustee in accordance with the Litigation Trust Agreement.

**(f) Third Party Agreements.**

The Distributions to the various Classes of Claims and Interests hereunder shall not affect the right of any Person to levy, garnish, attach, or employ any other legal process with respect to such Distributions by reason of any claimed subordination rights or otherwise. All of such rights and any agreements relating thereto shall remain in full force and effect, except as compromised and settled pursuant to the Plan. Distributions shall be subject to and modified by any Final Order directing distributions other than as provided in the Plan.

**(g) Amendment or Modification of Plan.**

As provided in section 1127 of the Bankruptcy Code, modification of the Plan may be proposed in writing by the Plan Proponents at any time before Confirmation, provided that the Plan, as modified, meets the requirements of sections 1122 and 1123 of the Bankruptcy Code, and the Plan Proponents shall have complied with section 1125 of the Bankruptcy Code. Either the Plan Proponents or Newco may modify the Plan at any time after Confirmation and before consummation of the Plan, provided that the Plan, as modified, meets the requirements of sections 1122 and 1123 of the Bankruptcy Code and the Bankruptcy Court, after notice and a hearing, confirms the Plan as modified, under section 1129 of the Bankruptcy Code, and the circumstances warrant such modifications. A Holder of a Claim that has accepted the Plan shall be deemed to have accepted such Plan as modified if the proposed alteration, amendment or modification does not materially and adversely change the treatment of the Claim or Interest of such Holder.

**(h) Severability.**

In the event that the Bankruptcy Court determines, prior to the Confirmation Date, that any provision in the Plan is invalid, void or unenforceable, Plan Proponents may, at its option, (a) treat such provision as invalid, void or unenforceable with respect to the Holder or Holders of such Claims or Interests that the provision is determined to be invalid, void or unenforceable, in which case such provision shall in no way limit or affect the enforceability and operative effect of any other provision of the Plan, or (b) alter, amend, revoke, or withdraw the Plan.

**(i) Revocation or Withdrawal of Plan.**

The Plan Proponents reserve the right to revoke and withdraw the Plan or to adjourn the Confirmation Hearing at any time prior to the occurrence of the Effective Date. If the Plan Proponents revoke or withdraw the Plan, or if Confirmation or consummation does not occur, then (i) the Plan shall be null and void in all respects, (ii) any settlement or compromise embodied in the Plan, assumption or rejection of executory contracts or unexpired leases under the Plan, and any document or agreement executed pursuant to the Plan, shall be deemed null and void, and (iii) nothing contained in the Plan shall (A) constitute a waiver or release of any Claims by or against, or Interests in, such Debtors or any other Person, (B) prejudice in any manner the rights of such Debtors or any other Person, or (C) constitute an admission of any sort by the Debtors or any other Person.

For the avoidance of doubt, if the Confirmation Hearing is adjourned, the Plan Proponents reserve the right to amend, modify, revoke or withdraw the Plan and/or submit any new plan of reorganization at such times and in such manner as they consider appropriate, subject to the provisions of the Bankruptcy Code.

**(j) Rules Governing Conflicts Between Documents**

In the event of a conflict between the terms or provisions of the Plan and the Plan Documents, the terms of the Plan shall control over the Plan Documents. In the event of a conflict between the terms of the Plan or the Plan Documents, on the one hand, and the terms of

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the Confirmation Order, on the other hand, the terms of the Confirmation Order shall control. In the event of a conflict between the information contained in the Disclosure Statement and the Plan or any other Plan Document, the Plan or other Plan Document (as the case may be) shall control.

**(k) Governing Law.**

Except to the extent that federal law (including, but not limited to, the Bankruptcy Code and the Bankruptcy Rules) is applicable or the Plan provides otherwise, the rights and obligations arising under the Plan shall be governed by, and construed and enforced in accordance with, the laws of the State of New York without giving effect to its conflicts of law principles.

**(l) Notices.**

Any notice required or permitted to be provided under the Plan shall be in writing and served by either (a) certified mail, return receipt requested, postage prepaid, (b) hand delivery, or (c) reputable overnight delivery service, freight prepaid. If to the Plan Proponents and the Reorganized Entities, any such notice shall be directed to the following at the addresses set forth below:

Mendocino Redwood Company, LLC  
1360 19th Hole Drive, Suite 200  
Windsor, CA 95492  
Attention: Richard Higgenbottom, Chief Executive Officer  
E-mail: *rhiggenbottom@mendoco.com*  
Telecopy: (707) 485-7918

with a copy to:

Sansome Partners, LLC  
One Maritime Plaza, 14<sup>th</sup> Floor  
San Francisco, California 94111  
Attention: Alexander L. Dean  
Email: *sandy@sansome.com*  
Telecopy: (415) 288-0549

and

Perkins Coie LLP  
131 South Dearborn Street, Suite 1700  
Chicago, IL 60603-5559  
Attention: Kenneth M. Crane, Esq.  
Peter G. Lawrence, Esq.  
E-mail: *KCrane@perkinscoie.com*  
*PLawrence@perkinscoie.com*  
Telecopy: (312) 324-9400

and

Marathon Structured Finance Fund L.P.  
461 Fifth Avenue 14<sup>th</sup> Floor  
New York, NY 10017  
Attention: Christine Chartouni, Esq.  
E-mail: *cchartouni@marathonfund.com*  
Telecopy: (212) 381-4495

with a copy to:

Winston & Strawn LLP  
200 Park Avenue  
New York, NY 10166  
Attention: David Neier, Esq.  
Carey D. Schreiber, Esq.  
E-mail: *dneier@winston.com*  
*cschreiber@winston.com*  
Telecopy: (212) 294-4700

**(m) Interest and Attorneys' Fees.**

Interest accrued after the Petition Date shall accrue and be paid on Claims only to the extent specifically provided for in the Plan, the Confirmation Order or as otherwise required by the Bankruptcy Court or by applicable law. No award or reimbursement of attorneys' fees or related expenses or disbursements shall be allowed on, or in connection with, any Claim, except as set forth in the Plan or as ordered by the Bankruptcy Court.

**(n) Binding Effect.**

The Plan shall be binding upon the Debtors, the Reorganized Entities, the Holders of all Claims and Interests, parties in interest, Persons, Entities and Governmental Units and their respective successors and assigns. To the extent any provision of the Disclosure Statement or any other solicitation document may be inconsistent with the terms of the Plan, the terms of the Plan shall be binding and conclusive.

**(o) No Admissions.**

As to contested matters, adversary proceedings and other Causes of Action or threatened Causes of Actions, nothing in the Plan, Disclosure Statement or other Plan Documents shall constitute or be construed as an admission by any Person of any fact or liability, stipulation, or waiver, but rather as a statement made in settlement negotiations. The Plan shall not be construed to be conclusive advice on the tax, securities, and other legal effects of the Plan as to Holders of Claims against, or Interests in, the Debtors or any of their subsidiaries and affiliates, as debtors and debtors-in-possession in these Reorganization Cases.

(p) **Exhibits.**

All Exhibits and Schedules to the Plan are incorporated into and are a part of the Plan as if set forth in full herein.

**SECTION 7.  
RISKS OF THE PLAN**

**7.1. General.**

The following is a summary of various risks associated with the Plan. However, it is not exhaustive and should be supplemented by careful analysis and evaluation of the Plan and this Disclosure Statement as a whole by each Holder of a Claim or an Interest with that Holder's own advisors.

**7.2. Confirmation Risks.**

In order for a plan to be confirmed, the Bankruptcy Code generally requires that impaired Classes vote to accept the Plan. This requires that voting creditors in each Class approve the Plan by (i) a number of creditors that is more than one half of the number of Claims in such Class; and (ii) a number of creditors that is at least two-thirds in dollar amount of the dollar amount of Claims in such Class.

There is no guarantee that these thresholds will be reached or that the Bankruptcy Court will concur with the vote tally. Any objection to the Plan also could prevent Confirmation of the Plan or delay such Confirmation for a significant period of time. Although the Plan Proponents believe that the Plan will satisfy all requirements necessary for Confirmation by the Bankruptcy Court, there is no assurance that the Bankruptcy Court will reach the same conclusion or that the Confirmation, if challenged on appeal, will be affirmed.

**7.3. Execution Risks.**

[To be provided]

**7.4. Variance from Reorganized Entities' Pro Forma Financial Projections.**

The information contained in Reorganized Entities' Pro Forma Financial Projections is an estimate by the Plan Proponents based on what currently are believed to be reasonable assumptions regarding the future earnings of the Reorganized Entities. Unanticipated events and circumstances occurring subsequent to the preparation of Reorganized Entities' Pro Forma Financial Projections may affect the actual pro forma financial results of the Reorganized Entities. Although the Plan Proponents believe that Reorganized Entities' projections are reasonable and attainable, some or all of the estimates will vary from actual results, and variations between the actual financial results and those projected may be material and adverse.

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The Pro Forma Financial Projections are based upon numerous assumptions regarding (a) the anticipated future performance of the Reorganized Entities, (b) the Confirmation and consummation of the Plan in accordance with its terms, (c) general business and economic conditions, and (d) certain other matters, many of which are beyond the control of the Plan Proponents. There is no assurance that such assumptions will prove to be valid. The effect of any variance from the projections may be material and adverse.

### **7.5. Regulatory and Environmental Risks.**

(a) Laws, regulations and related judicial decisions and administrative interpretations dealing with forest product operations are subject to change and new laws and regulations are frequently introduced concerning the California timber industry. From time to time, bills are introduced or ballot initiatives commenced relating to the Debtors' forest products operations. Such regulatory and legislative actions have the ability to significantly restrict and ultimately limit harvest levels and may require Reorganized Entities to incur additional costs, cause delays in obtaining THP approvals, reduce cash flows, and have other material adverse consequences.

### **7.6. Litigation Risks.**

Litigation proceedings could result in adverse effects on the Reorganized Entities. The Debtors were involved in a variety of pending legal proceedings as of the Petition Date. While these legal proceedings are in general stayed as against the Debtors while the companies are in bankruptcy, such proceedings could be continued if the stay is modified by the Bankruptcy Court, if the Reorganization Cases are dismissed, or in certain circumstances, upon the emergence of the Debtors from bankruptcy. Moreover, additional legal proceedings could be filed against any of the Reorganized Entities, increasing litigation costs and subjecting the Reorganized Entities to potential liability.

### **7.7. Commodity Risk.**

Lumber is a commodity and subject to the particular vagaries and unpredictability of commodity markets and commodity pricing. Historically, lumber prices have been subject to wide swings in price. The demand for lumber is affected primarily by the level of new construction activity, and to a lesser extent, remodeling and repair activity, and other industrial uses. These activities are subject to fluctuations due to factors including, but not limited to, the following: changes in domestic and international economic conditions, interest rates or the availability of financing, population growth and changing demographics, availability of contract loggers, damage by fire, insect infestation, or disease, prolonged drought, seasonal weather cycles and other weather driven events. For example, adverse and wet weather conditions could restrict the Reorganized Entities' ability to harvest timber using efficient logging methods. Also, decreases in the level of residential construction activity or repair and remodeling activity generally reduce demand for logs and wood products. In addition, timber owners generally increase production volumes for logs and related products during favorable price environments. Such increased production, however, when coupled with declines in demand for products in general, could lead to oversupply and lower prices. This can adversely affect cash flows for the Reorganized Entities.



**7.8. Risk of Post-Confirmation Default.**

The Plan Proponents believe that there is sufficient committed capital and operating cash flow to meet the Reorganized Entities' operating requirements, including obligations with respect to Priority Tax Claims and any notes issued under the Plan. Reorganized Entities' projected operating cash flow is set forth in Exhibit [D] to this Disclosure Statement. At the Confirmation Hearing, the Bankruptcy Court will be required to make a judicial determination that the Plan is feasible.

**SECTION 8.  
ALTERNATIVES TO THE PLAN**

If the Plan is not confirmed and consummated, alternatives to the Plan include (a) an alternative plan of reorganization, (b) liquidation of the Debtors under chapter 7 of the Bankruptcy Code, and (c) dismissal of the Reorganization Cases.

**8.1. Alternative Plan of Reorganization.**

Because exclusivity has been terminated, any party in interest could attempt to formulate a different plan of reorganization. The Plan Proponents believe that the Confirmation and implementation of the Plan is preferable to any of the liquidation alternatives because it would provide greater recoveries than those available in liquidation.

**8.2. Liquidation under Chapter 7.**

If the Plan cannot be confirmed, the Debtors' Reorganization Cases may be converted to cases under chapter 7 of the Bankruptcy Code, pursuant to which a trustee or trustees would be appointed to liquidate the assets of the Debtors for distribution in accordance with the priorities established by the Bankruptcy Code.

The Liquidation Analysis prepared by the Plan Proponents is attached to this Disclosure Statement as Exhibit C. As indicated in the assumptions listed in the Liquidation Analysis, two of the principal assumptions underlying the results of the Liquidation Analysis are that the trustee in a chapter 7 proceeding would sell the assets of the Debtors individually rather than on a going-concern basis and that the sales would be effected in a relatively short time frame of six months. The Plan Proponents believe that the value of their businesses, partially consolidated as a going concern, realizable through the cash flow generated by the consolidated operation, greatly exceeds the value of its component assets. Moreover, the Plan Proponents believe that the quick sale of those component assets by a chapter 7 trustee will not generate even fair market value for those individual assets.

The Liquidation Analysis takes into account the nature, status, and underlying value of their assets, the ultimate realizable value of their assets, and the extent to which such assets are subject to liens and security interests. Based on this analysis, it is likely that a chapter 7 liquidation of the Debtors' Assets would produce less value for distribution to creditors than that recoverable in each instance under the Plan. In the opinion of the Plan Proponents, the recoveries projected to be available in a chapter 7 liquidation are not likely to afford Holders of

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Claims and Holders of Interests as great a realization potential as does the Plan. In fact, the projected recoveries are not sufficient to satisfy the claims of the Debtors' various secured creditors. As a result, the Debtors' Unsecured Creditors would likely receive no distributions in a liquidation under chapter 7 or chapter 11.

The Liquidation Analysis is based upon a number of estimates and assumptions which, while considered reasonable, are inherently beyond the control of the Plan Proponents, the Debtors or any chapter 7 trustee. There can be no assurances that the values reflected in the Liquidation Analysis would be realized if the Debtors were to undergo such liquidation. Instead, actual results could vary materially from those shown in the Liquidation Analysis. In addition, any liquidation necessarily would take place in the future under circumstances that presently cannot be predicted. Accordingly, if the Debtors' Estates were liquidated, the actual liquidation proceeds could be materially lower or higher than the amounts set forth in the Liquidation Analysis, and no representation or warranty can be made with respect to the actual proceeds that could be received in chapter 7 liquidation proceedings.

### **8.3. Dismissal**

If the Plan cannot be Confirmed or if all conditions to effectiveness of the Plan are not met, any party in interest could request dismissal of the Reorganization Cases, the effect of which would be to return the Debtors to their pre-filing status as non-debtors. The Bankruptcy Court would determine whether dismissal was appropriate.

## **SECTION 9. CORPORATE GOVERNANCE AND EMPLOYEE-RELATED AGREEMENTS AND BENEFIT PLANS**

### **9.1. Corporate Governance Documents for the Reorganized Entities.**

As of the Effective Date, the certificates of formation and the limited liability company operating agreements of the Reorganized Entities will be substantially in the forms included in the Plan Supplement, with such changes as may be necessary to conform to the applicable laws of the state of formation. The initial certificates of formation and the limited liability company operating agreements of the Reorganized Entities, among other things, will prohibit the issuance of nonvoting equity securities to the extent required by section 1123(a) of the Bankruptcy Code. After the Effective Date, the Reorganized Entities may amend and restate their certificates of formation and the limited liability company operating agreements, as permitted under applicable state laws, subject to the terms and conditions of such documents.

### **9.2. Post Effective-Date Management of the Reorganized Entities.**

Except as expressly provided in the Plan and Reorganized Entities' certificate of incorporation, which certificate may be amended from time to time, the operation, management and control of the Reorganized Entities will be the general responsibility of its board of directors or managers and senior officers, which will thereafter have the responsibility for the management, control and operation of the Reorganized Entities.

**9.3. Directors and Officers of the Reorganized Entities.**

On and after the Effective Date, the business and affairs of the Reorganized Entities will be managed by the officers and directors, or managers identified in this Disclosure Statements, as supplemented or otherwise modified by the Plan Supplement. Biographical information regarding these proposed officers, directors, and managers has been set forth in this Disclosure Statement, as will be supplemented or otherwise modified in the Plan Supplement. A schedule of the annual compensation to be paid to persons serving as executives, officers and directors or managers as of the Effective Date will be set forth in the Plan Supplement.

**9.4. Director and Executive Compensation.**

A schedule of the annual compensation to be paid to persons serving as executives, officers and directors-managers of the Reorganized Entities, as the case may be, as of the Effective Date will be set forth in the Plan Supplement.

**9.5. New Employment, Retirement, Indemnification and Other Related Agreements.**

As of the Effective Date, the Reorganized Entities, as the case may be, will have the authority, as determined by its respective governing Persons or Entities, to: (i) maintain, amend or revise existing employment, retirement, welfare, incentive, severance, indemnification and other agreements with its active and retired directors, officers and employees, subject to the terms and conditions of any such agreement; and (ii) enter into new employment, retirement, welfare, incentive, severance, indemnification and other agreements for active and retired employees.

**SECTION 10.**

**CERTAIN FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN**

**IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, you are hereby notified that: (a) any discussion of U.S. federal tax issues in this document is not intended or written by us to be relied upon, and cannot be relied upon by Creditors, for the purpose of avoiding penalties that may be imposed on such Creditors under the Internal Revenue Code; (b) such discussion is written in connection with the promotion or marketing of the transactions or matters addressed herein; and (c) each Creditor should seek advice based on its particular circumstances from an independent tax advisor.**

The following is a summary of the anticipated material federal income tax consequences of the implementation of the Plan to the Debtors or Creditors.

**10.1. Scope of This Summary.**

This summary is based on the Internal Revenue Code, final and temporary Treasury Regulations promulgated thereunder, administrative pronouncements or practices, and judicial

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decisions, all as of the date hereof. Future legislative, judicial, or administrative modifications, revocations, or interpretations, which may or may not be retroactive, may result in federal income tax consequences significantly different from those discussed herein. This summary is not binding on the IRS or U.S. courts, and no assurance can be given that the conclusions reached in this summary will not be challenged by the IRS or will be sustained by a U.S. court if so challenged. In addition, the Debtors have not requested, and do not intend to request, a ruling from the IRS regarding any of the federal income tax consequences of the implementation of the Plan to the Debtors or Creditors.

This summary does not address the federal income tax consequences to certain categories of Creditors subject to special rules, including Creditors that are (a) banks, financial institutions, or insurance companies, (b) real estate investment trusts, cooperatives, regulated investment companies, mutual funds, or small business investment companies, (c) brokers or dealers in securities, (d) tax-exempt organizations, (e) investors in pass-through entities and such entities themselves, and (f) foreign taxpayers. Furthermore, this summary is limited to U.S. federal income tax consequences and does not discuss state, local or foreign tax consequences or federal estate or gift tax consequences.

This summary is for general information purposes only and does not purport to be a complete analysis or listing of all potential federal income tax consequences that may apply to the Debtors and Creditors as a result of the implementation of the Plan. In addition, this summary does not take into account the individual facts and circumstances of any particular Creditor that may affect the federal income tax consequences to such Creditor of the implementation of the Plan. Accordingly, this summary is not intended to be, and should not be construed as, legal or federal income tax advice with respect to any Creditor. Each Creditor should consult its own tax advisor regarding the federal, state, local, and foreign tax consequences of the Plan.

### **10.2. Federal Income Tax Consequences to the Debtors.**

As more particularly discussed below, it is not expected that the implementation of the Plan will create a federal tax liability or a tax refund for the Reorganized Entities.

#### **(a) Cancellation of Indebtedness.**

Under the Internal Revenue Code, a taxpayer generally must include in gross income the amount of any cancellation of indebtedness income ("COD Income") realized during the taxable year. Section 108 of the Internal Revenue Code provides that a taxpayer does not realize COD Income from cancellation of indebtedness to the extent that payment of such indebtedness would have given rise to an income tax deduction. Section 108 of the Internal Revenue Code provides further that if (i) a cancellation occurs in a case under the Bankruptcy Code, (ii) the taxpayer is under the jurisdiction of a bankruptcy court, and (iii) the cancellation is granted by the court or is pursuant to a plan approved by the court, then the COD Income may be excluded from gross income but must be applied to reduce certain tax attributes of the taxpayer.

Under the Plan, certain debt will be cancelled; this should not give rise to COD Income. Accordingly, the Plan should not give rise to COD Income to the Reorganized Entities (except to

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the extent that any interest previously accrued and deducted by the Debtors is not required to be paid) with respect to Administrative Expense Claims, Priority Tax Claims, or Claims in all Classes so as to bring into operation section 108 of the Internal Revenue Code.

### **(b) Tax Treatment of Mergers.**

The mergers proposed under the Plan will not constitute a taxable transaction for federal tax purposes because the Debtors are generally disregarded entities for federal tax purposes. It is possible that the mergers of certain Debtors could constitute a taxable transaction for federal tax purposes. However, no taxable gain would be recognized by the Reorganized Entities, since Britt, Scotia Inn, and Palco are all part of the same consolidated group for federal income tax purposes.

### **(c) Impact on Debtors' NOLs.**

#### **(1) Section 382 Limitation on NOLs.**

In general, if a taxpayer's deductions in a given year exceed taxable income for the year, the taxpayer may carry the excess (a net operating loss or "NOL") back to the two previous taxable years and forward to the next 20 taxable years. If the taxpayer paid income taxes in a carryback year, it may be entitled to a refund of those taxes. An NOL carry forward, on the other hand, will generally reduce or eliminate the taxes payable in one or more carry forward years. Section 382 of the Internal Revenue Code, however, limits a corporate taxpayer's utilization of an NOL following a Section 382 Ownership Change. A Section 382 Ownership Change occurs when the percentage of stock (determined on the basis of value) owned by one or more Holders of at least 5% of such stock increases by more than 50 percentage points (in relationship to the corporation's total stock considered to be outstanding for this purpose) from the lowest percentage of stock that was owned by such 5% shareholders at any time during the applicable "testing period. The testing period is ordinarily the shorter of (i) the three-year period preceding the date of testing or (ii) the period of time since the most recent ownership change of the corporation. In general, for purposes of determining stock ownership under section 382 of the Internal Revenue Code, stock owned by an entity is deemed owned proportionately by its owners and, with certain exceptions, all persons holding less than 5% of the value of the corporation's stock are treated as a single 5% shareholder. When the limitation under section 382 (the "Section 382 Limitation ) applies, the maximum amount of Pre-Section 382 Ownership Change NOLs that may be utilized by the corporate taxpayer to offset taxable income in taxable years following the Section 382 Ownership Change is limited to an annual amount generally equal to the product of (i) the applicable federal long-term exempt rate in effect on the date of the ownership change and (ii) the value of the taxpayer's equity immediately prior to the change (the "Annual Limitation ). Any unused Annual Limitation may be carried forward to increase the amount of income that may be offset by the NOL in subsequent years.

#### **(2) Effects of the Implementation of the Plan on the Debtor's NOLs.**

[To be supplied]

**10.3. Federal Income Tax Consequences to Creditors.**

**(a) Distributions of Cash or Notes in Satisfaction of Claims.**

In general, each Creditor who receives Cash in satisfaction of its Claims (other than any Claim for accrued but unpaid interest) will recognize gain or loss in an amount equal to the difference between (a) the amount of any Cash received by such Creditor in satisfaction of such Claim and (b) the Creditor's adjusted tax basis in such Claim. Where gain or loss is recognized by a Creditor, the character of such gain or loss as long-term or short-term capital gain or loss or as ordinary income or loss will be determined by a number of factors, including the tax status of the Creditor, whether the Claim constitutes a capital asset in the hands of the Creditor and how long it has been held, whether the Claim was acquired at a market discount and whether and to what extent the Creditor had previously claimed a bad debt deduction.

The treatment of a Creditor who receives solely New Timber Notes in satisfaction of Scopac Timber Note Claims will depend upon whether Claims surrendered and the Notes received each constitute "securities" of Newco within the meaning of the tax law. If the Claims surrendered and the Notes received each constitute "securities" of Newco within the meaning of the tax law, then the Creditor would recognize no gain or loss on the receipt of the Notes (except to the extent amounts are received for accrued but unpaid interest). If either the Claims surrendered or the Notes received do not constitute "securities" of Newco within the meaning of the tax law, then the Creditor would have taxable gain or loss determined as described in the preceding paragraph. In general, a debt instrument with an original term of less than five (5) years will not constitute a "security" within the meaning of the tax law. The Scopac Timber Note Claims and the New Timber Notes will likely be treated as securities for tax purposes.

To the extent that any amount received by a Creditor is received in satisfaction of accrued interest or accrued original issue discount ("OID") during its holding period, such amount will be taxable to the Creditor as interest income (but only to the extent not previously included in the Creditor's gross income) regardless of whether the Creditor otherwise recognizes a loss as a result of the overall transaction.

**(b) Market Discount.**

A Creditor that purchased its Claim from a prior Holder with market discount will be subject to the market discount rules of the Internal Revenue Code. Under those rules, assuming that the Creditor has made no election to amortize the market discount into income on a current basis with respect to any market discount instrument, any gain recognized on the satisfaction of its Claim (subject to a *de minimis* rule) generally would be characterized as ordinary income to the extent of the accrued market discount on such Claim as of the date of payment.

**(c) Information Reporting; Backup Withholding Tax.**

Distributions made pursuant to the Plan will generally be subject to applicable federal income tax information reporting and withholding. The Internal Revenue Code imposes backup withholding tax, currently at the rate of 28 percent, on certain payments, including payments of interest, if a taxpayer (a) fails to furnish its correct taxpayer identification number (generally on

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Form W-9), (b) furnishes an incorrect taxpayer identification number, (c) is notified by the IRS that it has previously failed to report properly items subject to backup withholding tax, or (d) fails to certify, under penalty of perjury, that such taxpayer has furnished its correct taxpayer identification number and that the IRS has not notified such taxpayer that it is subject to backup withholding tax. However, taxpayers that are corporations generally are excluded from these information reporting and backup withholding tax rules. Backup withholding is not an additional federal income tax. Any amounts withheld under the backup withholding tax rules will be allowed as a credit against a taxpayer's federal income tax liability, if any, or will be refunded to the extent it exceeds such liability, if such taxpayer furnishes required information to the IRS. A taxpayer that does not provide a correct taxpayer identification number may be subject to penalties imposed by the IRS. Each taxpayer should consult its own tax advisor regarding the information reporting and backup withholding tax rules.

### **10.4. Importance of Obtaining Professional Tax Assistance.**

This discussion is intended only as a summary of certain federal income tax consequences of the Plan, and is not a substitute for careful tax planning with a tax professional. The tax consequences are in many cases uncertain and may vary depending on a Holder's individual circumstances. Accordingly, Holders are urged to consult with their tax advisors about the federal, state, local, and foreign tax consequences of the Plan.

## **SECTION 11. FINANCIAL INFORMATION**

### **11.1. General.**

An analysis of the Debtors' financial condition will be included in exhibits to this Disclosure Statement. This information is provided to permit Holders of Claims and Interests to better understand the Debtors' financial condition.

The Debtors are required to file monthly operating reports with the Bankruptcy Court. Such financial information is on file with the clerk of the Bankruptcy Court and publicly available for review on the Bankruptcy Court's public website: [www.txsb.uscourts.gov](http://www.txsb.uscourts.gov).

### **11.2. Reorganized Entities' Financial Projections.**

Exhibit D to this Disclosure Statement includes financial projections which represent the Plan Proponents' present judgment of the projected business operations of Reorganized Palco and Reorganized Scopac. The projections are estimates by the Plan Proponents based on what are currently believed to be reasonable assumptions regarding the future earnings of the Reorganized Entities and are subject to the limitations and conditions stated in the notes to the projections. Unanticipated events and circumstances occurring subsequent to the preparation of the financial projections may affect the actual financial results of the Reorganized Entities. While the Plan Proponents believe that the financial projections are reasonable, as they are based upon the assumptions set forth in connection with such projections, some or all of the estimates will vary. Variations between the actual financial results and those projected, moreover, may be material and adverse.

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The financial projections are based upon numerous assumptions regarding (a) the tax consequences of the Plan (see Section 11 above); (b) the anticipated future performance of the Reorganized Entities; (c) the Confirmation and consummation of the Plan in accordance with its terms; (d) general business and economic conditions; and (e) certain other matters, many of which are beyond the control of the Plan Proponents and Reorganized Entities. There can be no assurance that such assumptions will prove to be valid, and the effect of any variance from the projections may be material and adverse.

- (a) **Summary of Reorganized Entities' Financial Projections for Newco's Timberlands.**

[redacted]

- (b) **Summary of Reorganized Entities' Financial Projections for Newco's Mill and Related Distribution Business.**

[redacted]

**WHILE THE PLAN PROPONENTS BELIEVE THAT THE FINANCIAL PROJECTIONS ARE REASONABLE IN LIGHT OF CURRENT FACTS AND CIRCUMSTANCES KNOWN TO THE PLAN PROPONENTS, THE PROJECTIONS ARE BASED ON A NUMBER OF ASSUMPTIONS AND ARE SUBJECT TO SIGNIFICANT UNCERTAINTIES WHICH ARE BEYOND THE CONTROL OF THE REORGANIZED ENTITIES. THEREFORE, THERE CAN BE NO ASSURANCE THAT THESE PROJECTIONS WILL BE REALIZED. THE ACTUAL OPERATING RESULTS MAY BE MATERIALLY HIGHER OR LOWER THAN THE PRESENT FORECAST.**

### **SECTION 12. SOURCES OF INFORMATION PROVIDED AND THE ACCOUNTING METHOD USED**

#### **12.1. Sources of Information.**

The information set forth in this Disclosure Statement and the attached exhibits was provided by the Plan Proponents and their professionals. The financial information in the exhibits to this Disclosure Statement was provided by the Plan Proponents or is based upon data generated by the Debtors

#### **12.2. Accounting Method.**

The Debtors maintain their books and records in accordance with generally accepted accounting principles used in the United States.



**SECTION 13.  
REQUIREMENTS FOR CONFIRMATION OF THE PLAN AND VOTING  
PROCEDURES**

**13.1. Acceptance or Rejection of the Plan.**

**(a) Requirements of 11 U.S.C. & 1124.**

Under the Bankruptcy Code, only classes of claims and interests that are impaired under a plan of reorganization can vote to accept or reject that plan. Under section 1124 of the Bankruptcy Code, a class of claims or interests is impaired under a plan unless, with respect to each claim or interest in that class, that plan:

- (1) leaves unaltered the legal, equitable, and contractual rights to which that claim or interest entitles its holder; or
- (2) notwithstanding any contractual provision or applicable law that entitles the holder of that claim or interest to demand or receive accelerated payment of that claim or interest after the occurrence of a default occurs:
  - A.** cures that default, if other than a default of a kind specified in section 365(b)(2) of the Bankruptcy Code or of a kind that section 365(b)(2) expressly does not require to be cured;
  - B.** reinstates the maturity of that claim or interest as it existed prior to that default;
  - C.** compensates the holder of that claim or interest for any damages that holder incurs as a result of that holder's reasonable reliance on that contractual provision or law;
  - D.** if such claim or such interest arises from any failure to perform a non-monetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for the any pecuniary loss incurred by such holder as a result of such failure; and
  - E.** does not otherwise alter the legal, equitable, or contractual rights to which that claim or interest entitles its holder.

Under the Plan, Classes 1 and 2 are unimpaired; therefore, the Holders of Claims in such Classes are conclusively presumed under section 1126(f) of the Bankruptcy Code to have accepted the Plan. The Debtors are not soliciting acceptances from these Classes.

**(b) Acceptance by Impaired Classes of Claims.**

Pursuant to section 1126(c) of the Bankruptcy Code and except as otherwise provided in section 1126(e) of the Bankruptcy Code, if the Bankruptcy Court authorizes the consolidation for certain purposes of certain of the Debtors, an Impaired Class of Claims from the consolidated Debtor group has accepted the Plan if the Holders of at least two-thirds in dollar amount and more than one-half in number of the Allowed Claims in such Class actually voting have voted to accept the Plan. If the Bankruptcy Court authorizes the Debtors to consolidate less than all of the certain Debtors' Estates that such treatment is requested, then an Impaired Class of Claims for each non-consolidated Debtor and an Impaired Class of Claims from the consolidated Debtor group, respectively, has accepted the Plan if the Holders of at least two-thirds in dollar amount and more than one-half in number of the Allowed Claims in such Class actually voting have voted to accept the Plan.

**(c) Tabulation of Votes on a Consolidated and Non-Consolidated Basis.**

The Plan Proponents will tabulate all votes on the Plan on a consolidated basis by class for the purpose of determining whether the Plan satisfies sections 1129(a)(8) and/or (10) of the Bankruptcy Code; *provided, however,* that if the Bankruptcy Court denies in whole or part the Plan Proponents for consolidation for certain voting and distribution purposes, the Plan Proponents will tabulate all votes on a non-consolidated basis by class for the Debtors that are not consolidated. If no impaired classes accept the Plan, the Plan Proponents may modify the Plan to appropriately address the rights of the Holders of Allowed Claims.

**13.2. Confirmation Hearing.**

Section 1128(a) of the Bankruptcy Code requires the Bankruptcy Court, after notice, to hold a hearing on confirmation of a proposed plan. The Confirmation Hearing has been scheduled for \_\_, 2008 at \_\_ \_\_.m. before the Honorable Richard S. Schmidt, United States Bankruptcy Judge for the Southern District of Texas, in his courtroom located at 1133 N. Shoreline Blvd., Second Floor, Corpus Christi, Texas. The Bankruptcy Court may adjourn the Confirmation Hearing from time to time without further notice except for an announcement of the adjourned date made at the Confirmation Hearing or any subsequent adjourned Confirmation Hearing.

Section 1128(b) of the Bankruptcy Code provides that any party in interest may object to confirmation of a plan. Unless otherwise directed or permitted by the Bankruptcy Court, any objection to Confirmation of the Plan must (1) be in writing, (2) conform to the Bankruptcy Rules, (3) set forth the name of the objecting party, (4) identify the nature of Claims or Interests held or asserted by the objector against the Debtors' Estates or property, (5) state the basis for the objection and the specific grounds therefore, (6) be filed with the clerk of the Bankruptcy Court, together with proof of service, and served upon each of the following so as to be received in the offices of each such Persons no later than \_\_, 2008 at 4:00 p.m., prevailing Central Time: (a) Jack L. Kinzie, Baker Botts L.L.P., 2001 Ross Avenue, Dallas, Texas 75201-2980; (b) Shelby A. Jordan, Jordan, Hyden, Womble, Culbreth, & Holzer, P.C., Suite 900, Bank of America, 500 North Shoreline, Corpus Christi, Texas 78471; (c) Kathryn A. Coleman, Gibson, Dunn &

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Crutcher LLP, 200 Park Ave, 47th Floor, New York, NY 10166-0193; (d) Kyung S. Lee, Diamond McCarthy LLP, 909 Fannin, Suite 1500, Houston, Texas 77002; and (e) John D. Fiero, Pachulski, Stang, Ziehl, Young, Jones & Weintraub, 150 California Street, 15th floor, San Francisco, CA 94111-4500.

### **13.3. Requirements for Confirmation.**

#### **(a) Consensual Confirmation Under Section 1129(a) of the Bankruptcy Code.**

At the Confirmation Hearing, the Bankruptcy Court will be asked to determine whether the requirements of section 1129(a) of the Bankruptcy Code have been satisfied. These requirements include, among others, judicial findings that:

- the Plan complies with applicable provisions of the Bankruptcy Code;
- the Plan Proponents have complied with the applicable provisions of the Bankruptcy Code;
- the Plan has been proposed in good faith and not by any means forbidden by law;
- any payment made or promised by the Plan Proponents to any Person for services, costs, or expenses in connection with the Reorganization Cases or the Plan has been approved by, or is subject to the approval of, the Bankruptcy Court as reasonable;
- the Plan Proponents have disclosed the identity and affiliations of any individual proposed to serve as an officer, director, or manager of the Reorganized Entities after Confirmation of the Plan and that the appointment to, or continuance in, such office by such individual is consistent with the interests of Holders of Claims and Interests and with public policy;
- except to the extent the Plan meets the "Nonconsensual Confirmation" standards discussed below, each Class of Claims or Interests has either accepted the Plan or is not impaired under the Plan;
- except to the extent that the Holder of a particular Claim has agreed to a different treatment of such Claim, the Plan provides that Administrative Expenses and Priority Claims will be paid in full on the Effective Date and that Priority Tax Claims will be either paid in full on the Effective Date or will receive on account of such Claims deferred cash payments, over a period not exceeding five years after the date of assessment of such Claims, of a value, as of the Effective Date, equal to the Allowed Amount of such Claims;
- at least one impaired and non-insider Class of Claims has accepted the Plan;
- that the Plan is feasible; that is, Confirmation is not likely to be followed by the liquidation or the need for further reorganization of the Reorganized Entities, unless such liquidation or reorganization is proposed in the Plan;

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- all fees payable under section 1930 of title 28 of the United States Code have been paid on or prior to the Effective Date;
- the Plan provides for the continuation after the Effective Date of payment of all retiree
- benefits, as that term is defined in section 1114 of the Bankruptcy Code, at the level established pursuant to section 1114(e)(1)(B) or (g), at any time prior to Confirmation of the Plan, for the duration of the period the Reorganized Entities have obligated themselves to provide such benefits; and
- the Plan is in the best interests of the Holders of Claims and Interests, as discussed in more depth below.

The Plan Proponents believe that the Plan satisfies all applicable requirements of section 1129(a) of the Bankruptcy Code.

### (b) **Best Interests Test.**

Under the best interests test, the Plan is confirmable if, with respect to each impaired Class of Claims or Interests, each Holder of a Claim or Interest in that Class either:

- has accepted the Plan; or
- will receive or retain under the Plan, on account of its Claim or Interest, property of a value, as of the Effective Date, that is not less than the amount that Holder would receive or retain if the Debtors were to be liquidated under chapter 7 of the Bankruptcy Code.

The Plan Proponents believe that the Plan will produce a greater recovery for Holders of Allowed Claims and Interests than would be achieved in a liquidation pursuant to chapter 7 of the Bankruptcy Code because, among other things, the additional Administrative Expense Claims generated by conversion to a chapter 7 case, the administrative costs of liquidation and associated delays in connection with a chapter 7 liquidation, and the negative impact on the markets for the Debtors' Assets of attempting to sell their Assets in a short time frame, each of which likely would diminish the value of the Debtors' Assets available for distributions. The Plan Proponents have prepared a Liquidation Analysis and a valuation analysis to assist Holders of Claims and Interests in determining whether to accept or reject the Plan. The Liquidation Analysis and valuation analysis compare the proceeds to be realized if the Debtors were to be liquidated in a hypothetical case under chapter 7 of the Bankruptcy Code with the Distributions to Holders of Allowed Claims and Interests under the Plan. The analyses are based upon the value of the Debtors' Assets and liabilities as of a certain date, and incorporate various estimates and assumptions, including a hypothetical conversion to a chapter 7 liquidation as of a certain date. Each analysis is subject to potentially material changes, including with respect to economic and business conditions and legal rulings. Therefore, the actual liquidation value of the Debtors could vary materially from the estimates provided in the Liquidation Analysis, and the actual

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total enterprise value and reorganization equity value of the Reorganized Entities could vary materially from the estimates contained in the valuation analysis.

Based upon the analysis set forth in the Liquidation Analysis (see Exhibit C), the Plan Proponents believe that the Distributions that would be made in a chapter 7 liquidation would be substantially smaller than the Distributions contemplated by the Plan. The Plan Proponents therefore believe that the Plan is in the best interests of all Holders of Claims and Interests.

### **(c) Feasibility of the Plan.**

In order for the Plan to be confirmed, the Bankruptcy Court also must determine that the Plan is feasible that is, that the need for further reorganization or a subsequent liquidation of the Reorganized Entities is not likely to result following Confirmation of the Plan. In determining whether a plan of reorganization is feasible, a court will consider:

- the adequacy of the proposed capital structure of the reorganized entity;
- the earning power of that entity;
- the overall economic conditions in which that entity will operate;
- the capability of its management;
- the continuity of its management; and
- any other factors the court deems relevant to the successful operation of the reorganized entity to perform the provisions of the plan of reorganization.

The Plan Proponents anticipate that the committed capital and cash flow generated from operations will be sufficient to pay their ongoing business expenses, including but not limited to satisfying their Environmental Obligations. The Plan Proponents believe that the Plan is feasible.

### **(d) Nonconsensual Confirmation under Section 1129(b) of the Bankruptcy Code.**

Although section 1129(a)(8) of the Bankruptcy Code requires that a plan be accepted by each class that is impaired by such plan, section 1129(b) of the Bankruptcy Code provides that the Bankruptcy Court may still confirm the Plan at the request of the Plan Proponents if all requirements of section 1129(a) (except section 1129(a)(8)) are met and if, with respect to each Class of Claims or Interests that is impaired under the Plan and has not voted to accept the Plan, the Plan "does not discriminate unfairly" and is "fair and equitable. A plan confirmed on the basis of this provision is commonly referred to as a "cramdown plan. In the event an impaired Class of Claims or Interests does not accept the Plan, the Plan Proponents may seek cramdown Confirmation of the Plan with respect to any such non-accepting Class. The Plan Proponents believe that, with respect to such Classes, the Plan meets the requirements of section 1129(b) of the Bankruptcy Code.

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- (1) Unfair Discrimination. A plan of reorganization does not discriminate unfairly if no class receives more than it is legally entitled to receive for its Claims or Equity Interests. **The Plan Proponents believe that the Plan meets this requirement.**
- (2) Fair and Equitable Test. "Fair and equitable has meanings for Secured Claims, Unsecured Claims, and Interests.

With respect to a Secured Claim, "fair and equitable means that the Plan provides either:

(a) that the Holder of a Secured Claim in an impaired Class retains the Liens securing such Claim, whether the property subject to such Liens is retained by the Debtor or transferred to another Entity, to the extent of the amount of such Allowed Claim, and that the Holder of such Claim receives on account of such Claim deferred Cash payments totaling at least the amount of such Allowed Claim, of a value, as of the Effective Date, of at least the value of such Holder's interest in the Estate's interest in such property;

(b) for the sale, subject to section 363(k) of the Bankruptcy Code, of any property that is subject to the Liens securing such Claim, 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 subsections (a) or (b) hereof; or

(c) the realization by such Holder of the "indubitable equivalent of such Claim.

With respect to an Unsecured Claim, "fair and equitable" means either (a) the Plan provides that each Holder of a Claim of such Class receive or retain on account of such Claim property of a value, as of the Effective Date of the Plan, equal to the Allowed Amount of such Claim; or (b) the Holder of any Claim or interest that is junior to the claims of such Class will not receive or retain any property under the Plan on account of such junior Claim or Interest.

With respect to an Interest, "fair and equitable" means either (a) each Holder of an Interest in an impaired Class receives or retains property of a value, as of the Effective Date of the Plan, equal to the greatest of the Allowed amount of any fixed liquidation preference to which such Holder is entitled, any fixed redemption price to which such Holder is entitled, or the value of such Interest; or (b) the Holder of any Interest that is junior to the Interests of such Class will not receive or retain any property under the Plan on account of such junior Interest.

**The Plan Proponents believe that the Plan will meet the fair and equitable test in the event that a Class of Claims does not accept the Plan, and that the Plan meets the fair and equitable test with regard to the Class of Interests, which are deemed to reject the Plan.**

**13.4 Conditions to Effectiveness.**

In addition to the requirements for Confirmation of the Plan, the terms of the Plan provide that the Plan may not become effective unless, among other things, (a) the Bankruptcy Court has approved this Disclosure Statement, (b) the Confirmation Order has become a Final Order, and (c) the Plan Documents necessary or appropriate to implement the Plan have been executed, delivered, and filed where applicable.

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See Article XI of the Plan for a full discussion of the conditions to effectiveness of the Plan.

Upon notice, the Plan Proponents, in their sole discretion, may waive any of the conditions to effectiveness.

### **13.4. Effect of Confirmation and Effectiveness.**

If the Plan is confirmed and becomes effective, the Plan will be binding upon the Debtors, all Holders of Claims and Interests, and all other parties in interest, regardless of whether they have accepted or rejected the Plan.

## **RECOMMENDATION AND CONCLUSION**

The Plan Proponents recommend that all Holders of Claims in Classes 3, 4, 6, 7, 8, 9, 10 and 11 vote to accept the Plan and return their Ballots in the enclosed envelope to the Balloting and Claims Agent *so that they will be received*, on or before **4:00 p.m.**, prevailing Central Time, on \_\_\_\_\_, **2008**.

In the view of the Plan Proponents, the Plan provides the best available alternative for providing equitable and expeditious distributions to Holders of Claims out of the Debtors' Estates. Your support of the Plan will enable it to be implemented and help ensure its success.

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The undersigned have executed this Disclosure Statement as of the \_\_\_\_\_ day of \_\_\_\_\_, 2008.

Respectfully submitted,

<p>Mendocino Redwood Company, LLC, as Plan Proponent</p> <p>By: _____ Name: Title:</p>	<p>Marathon Structured Finance Fund L.P., as Plan Proponent</p> <p>By: _____ Name: Title:</p>
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