No. 08–40746

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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

v.

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

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

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(1) 08–40746; *The Bank of New York Mellon Trust Company, N.A., as Indenture Trustee for the Timber Notes; Angelo Gordon & Co L.P., Aurelius Capital Management, LP, and Davidson Kempner Capital Management LLC; Scotia Pacific Company LLC; CSG Investments, Inc.; Scotia Redwood Foundation, Inc., Appellants v. Official Unsecured Creditors' Committee; Marathon Structured Finance Fund L.P.; Mendocino Redwood Company LLC; Pacific Lumber Co.; The Pacific Lumber Company; United States of America; California State Agencies, Appellees.*

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

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STATEMENT REGARDING ORAL ARGUMENT

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

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STATEMENT OF JURISDICTION

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

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

ISSUES PRESENTED

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

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

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

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

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

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

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

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

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

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

STANDARDS OF REVIEW

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

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

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

STATEMENT OF THE CASE

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

STATEMENT OF FACTS

I. The Major Parties.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

III. Palco's Separate Marathon Loans and Ongoing Losses.

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

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

IV. Filing of Plans.

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

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

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

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

V. Structure of the MRC/Marathon Plan.

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

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

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

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

A. The Palco Debtors' Assets Solely Benefit Marathon.

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

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

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

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

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

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

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

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

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

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

VI. The Plan's Manipulation of Voting Classes.

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

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

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

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

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

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

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

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

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

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

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

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

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

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[16] Class 5 votes to accept every proposed plan.
Class 6 votes to reject the MRC/Marathon Plan (124 of 130) totaled $688,729,517.
Class 8 votes to accept the MRC/Marathon Plan (26 of 27) totaled $241,382.
Class 9 votes to reject the MRC/Marathon Plan (125 of 132) totaled $688,729,517 on their face (over $227 million in deficiency claims per the terms of the MRC Plan). Dkt-2581, Exhibit A, pg. 1.

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

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

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