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UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re PROTOCOL SERVICES, INC., et al., Debtors.	Bankruptcy Nos. 05-06782-JM11 through 05-06786-JM11 (Jointly Administered) MEMORANDUM DECISION

The debtor entities ("Debtors") brought on for confirmation a plan of reorganization ("Plan"). Pursuant to the Plan, the Requisite Senior Lenders ("RSL") will receive secured notes and 58% of the equity in the reorganized Debtors. The remaining equity will be divided among the Mezzanine A and B Noteholders. An objection has been raised that this division of the equity violates the absolute priority rule. That objection is based on the decision in In re Armstrong World Industries, Inc., 320 B.R. 523 (D.Del. 2005), as well as the argument that the Noteholders are totally unsecured because the value of the Debtors does not exceed the amount of debt owed the RSL.

In Armstrong World, the debtor's proposed plan of reorganization placed general unsecured creditors in one class and certain asbestos personal injury claimants, who were also unsecured, were placed in a

separate class. Furthermore, warrants were to be given to an equity class, a class junior to the general unsecured creditors. Anticipating that unsecured creditors might reject the plan, the debtor proposed to distribute the warrants to the personal injury claimants if the class of general unsecured creditors rejected the plan. But then the personal injury class would automatically waive this distribution in favor of having the warrants distributed to equity. The debtor argued that this provision would not violate the absolute priority rule because the class of personal injury claimants had a right to grant the warrants to a lower class.

The district court rejected this argument. The court stated that the net result was that the equity class was receiving property of the debtor, i.e., the new warrants, on account of their equity interests, although a senior class – the unsecured creditors – would not have full satisfaction of their claims. It held that this arrangement violated the absolute priority rule.

The lead case for the opposing point of view is In re SPM Manufacturing Corp., 984 F.2d 1305 (1st Cir. 1983). In SPM, the secured creditor agreed to share proceeds of a sale of its collateral with unsecured creditors. The reorganization failed, and the entity ended up in Chapter 7. The issue before the court was whether the sharing agreement would be honored, even though this would mean that unsecured creditors would receive a distribution ahead of a priority claim. The court of appeals ruled that the agreement had to be applied, despite the priority scheme set forth in Section 726 of the Bankruptcy Code.

In distinguishing SPM, the court in Armstrong stated the following:

> the secured lender in SPM held a perfected, first security interest in all of the debtor's assets, with the exception of certain real estate. Although the agreement between the secured lender and the unsecured creditors implicated property of the estate, the property was not subject to distribution under the Bankruptcy Code's priority scheme.

The court also distinguished SPM as follows:

> Third, rather than viewing a distribution of the debtor's property in contravention to the Bankruptcy Code's distribution scheme, the sharing agreement approved in SPM may be more properly construed as an ordinary "carve out," i.e., "an agreement by a party secured by all or some of the assets of the estate to allow some portion of its lien proceeds to be paid to others [to secure their cooperation or to compensate priorities as part of cash collateral agreements]." [citations omitted] Unlike the Debtor in the instant case, the secured lender in SPM had a substantive right to dispose of its property, including the right to share the proceeds subject to its lien with other classes.

320 B.R. 523, 538-39.

The facts of SPM are consistent with the facts in this case, and justify its application herein, rather than the ruling in Armstrong World. The objecting parties contend the Debtors are not worth more than the amount of the debt owed the RSL. Furthermore, the RSL are secured by all or substantially all of the assets of the Debtors. As a result, they are entitled to grant equity to the Mezzanine A and B Noteholders as an acceptable carve-out provision.

The Official Creditors' Committee contends that the Net Operating Loss is an unencumbered asset. The RSL counter that the NOL is a general intangible to which their lien attaches. Resolution of that issue does not affect whether the RSL can agree to the carve-out because, as in SPM, the RSL are secured by substantially all of the Debtors' assets, whether or not that includes the NOL. However, to the extent the issue over the NOL needs to be resolved, the Court agrees with the position taken by the RSL. See In re TMCI Electronics, 279 B.R. 552, (N.D.Cal. 1999)(tax refund generated from

net operating loss was general intangible on which creditor's security interest could attached); In re Mammoth Spring Distributing Co., Inc., 139 B.R. 205 (W. Ark. 1992). Furthermore, as to any postpetition NOL to which the estate might be entitled, the Court agrees with the position of the senior lenders that the liens granted to the senior lenders pursuant to the cash collateral agreement entered postpetition attach to any postpetition NOL.

The Court is satisfied that the RSL have a right to agree to a carve-out from the collateral securing its lien. As a result, the Court rejects the argument that the plan provisions granting the Mezzanine A and B Noteholders equity in the Debtors are improper.

Date: DEC 23 2005

Hon. James W. Meyers
UNITED STATES BANKRUPTCY JUDGE