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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	
	:	Chapter 11 Case No.
Allegiance Telecom, Inc., et al.,	:	03-________ ( )
	:	
Debtors.	:	Jointly Administered

MOTION PURSUANT TO SECTIONS 105(a), 363, AND 541 OF THE BANKRUPTCY CODE FOR ORDER (A) AUTHORIZING THE DEBTORS TO PAY SALES AND USE TAXES AND REGULATORY AND UNIVERSAL SERVICE FEES, AND (B) AUTHORIZING AND DIRECTING APPLICABLE BANKS AND OTHER FINANCIAL INSTITUTIONS TO RECEIVE, PROCESS, HONOR AND PAY ALL CHECKS PRESENTED FOR PAYMENT

TO THE HONORABLE UNITED STATES BANKRUPTCY JUDGE:

Allegiance Telecom, Inc. and its direct and indirect subsidiaries, as debtors and debtors in possession (collectively, "Allegiance" or the "Debtors"), respectfully represent:

Introduction

1. On the date hereof (the "Commencement Date"), the Debtors each commenced with this Court a voluntary case under chapter 11 of title 11, United States Code (the "Bankruptcy Code"). The Debtors are authorized to operate their businesses and manage their properties as debtors in possession pursuant to sections 1107 and 1108

of the Bankruptcy Code. Simultaneously with the filing of their petitions and this Application, the Debtors requested an order for the joint administration of their chapter 11 cases pursuant rule 1015(b) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules").

Jurisdiction

2. This Court has subject matter jurisdiction to consider and determine this Motion pursuant to 28 U.S.C. § 1334. This is a core proceeding within the meaning of 28 U.S.C. § 157(b). Venue is proper before this court pursuant to 28 U.S.C. §§ 1408 and 1409.

An Overview of Allegiance's Business

3. Allegiance is a facilities-based national local exchange carrier that provides integrated telecommunications products and services to small and medium-sized business customers, large businesses (i.e., national customers with multiple locations), governmental entities, wholesale customers and other institutional users. Allegiance offers its customers a variety of services, including:

- local and long distance voice services, including basic telephone services and advanced calling features;
- broadband and other Internet and data services, including high-speed Internet access, wide area network interconnection, domain name registration, web hosting, email and colocation services;
- integrated local long distance/Internet access offerings, which provide customers with integrated voice and Internet access over a single broadband line;
- wholesale services to other regional and national service providers, including equipment colocation, managed modem ports and Internet protocol traffic aggregation; and
- customer premise equipment sales and maintenance services.

4. Allegiance serves more than 100,000 business customers in 36 markets. Allegiance employs approximately 3,560 people, of which approximately 97 employees are covered by collective bargaining agreements.

5. As of the Commencement Date, the Debtors have approximately $245 million of cash. As of December 31, 2002, the Debtors' consolidated books and records reflected assets totaling approximately $1.441 billion and liabilities totaling approximately $1.397 billion. For the three months ending December 31, 2002, the Debtors, on a consolidated basis, reported revenues of approximately $204.91 million, EBITDA (i.e., earnings before interest, taxes, depreciation, amortization, non-cash deferred compensation expense and non-cash goodwill impairment charges) of approximately negative $34 million and net losses of approximately $120 million.

Allegiance is Critical to Promoting Sustainable Competition in the Local Telecommunication Marketplace

The Telecommunications Act of 1996

6. In February of 1996, Congress enacted the Telecommunications Act of 1996 (the "Telecom Act"), with the stated purpose of:

> promot[ing] competition and reduc[ing] regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.

H.R. REP No. 104-204(I), 104th Cong. 1st Sess. 1995 (July 24, 1995), reprinted in 1996 U.S.C.C.A.N. 10, **10. In that regard, the Telecom Act required Incumbent Local Exchange Carriers, including the Regional Bell Operating Companies ("ILECs") – i.e., existing telecommunications monopolies – to allow newly created Competitive Local Exchange Carriers ("CLECs") to (a) interconnect with the ILECs, (b) access portions of the ILEC network and (c) collocate their equipment in ILEC facilities all at forwardlooking cost based rates. In addition, CLECs were permitted to purchase ILEC services at wholesale prices and resell them to customers at retail prices.

7. The enactment of the Telecom Act spurred entrepreneurs to start hundreds of new businesses to compete in the local telecommunications marketplace. During the late 1990s, investors recognized the growth opportunity inherent in the opening of a competitive local telecommunications marketplace and invested billions of dollars in equity and debt capital into a multitude of telecommunications companies primed to provide competing services to American consumers.

8. Funded with significant amounts of investment capital, two types of CLECs emerged. The first type of CLECs were "resellers". Specifically, "reseller" CLECs purchased telecommunications services from ILECs at a discount and resold the services to customers at a higher price. Thus, these CLECs simply offered consumers the same services supplied by ILECs - generally at lower prices. To be successful with this low margin business model, "reseller" CLECs invested their capital in sales and marketing efforts designed to acquire a substantial customer-base and attendant market-share in a relatively short period of time and ahead of their many competitors. However, because resellers were providing the identical services as the ILECs (with no differentiation) and were attempting to build a large market share in a highly competitive market, this business model was flawed and many in the telecommunications industry believe that the "resale" business will fail.

9. The second type of CLECs were "facilities-based" CLECs. These CLECs invested significant sums of money to build their own proprietary infrastructure and network in order to effectively compete with the ILECs. Specifically, facilities-based

CLECs combined elements of an ILEC's network with their own to provide consumers with true differentiated services. As Michael Powell stated in his partial dissent to the FCC's 2003 Triennial Review:

> Facilities -based competition means a competitor can offer real differentiated service to consumers . . . . Facilities-based competitors own more of their own network and control more of their costs, thereby offering consumers real potential for lower prices. Facilities-based competitors offer greater rewards for the economy – buying more equipment from other suppliers . . . and creating more jobs. . . . . And, facilities providers create vital redundant networks that can serve own nation if other facilities are damaged by those hostile to our way of life.

F.C.C., 2003 Triennial Review - Open Meeting, Separate Statement of Chairman Michael R. Powell, dissenting in part (February 20, 2003) (transcript available at www.fcc.gov/wcb/cpd/triennial_review/). Allegiance is such a facilities-based CLEC with a nationwide network and a facility-based business strategy.

The Allegiance Nationwide Network – Servicing 36 Metropolitan Areas

10. In 1997, a management team of industry veterans launched Allegiance and focused on building a reliable nationwide network based on proven technologies, a nationwide direct sales force primarily focused on the small to medium sized business enterprise and information processing systems to support its operations. Allegiance was one of the first major local exchange carriers to open markets utilizing the "smart build" strategy. This strategy allowed a more rapid ramp-up in operations than the traditional competitive local exchange model in which extensive networks were built, including fiber networks, prior to the generation of significant revenues. In contrast, Allegiance's initial network build-out simply required (a) deploying digital switching platforms with local and long distance capability and (b) leasing transport facilities from the incumbent local exchange carriers and other competitive local exchange carriers to

connect its switches with its transmission equipment colocated in the incumbent local exchange carrier's central offices. Once traffic volume justified further "success-based" investment, Allegiance leased dark fiber or built specific network segments. This strategy offered two major economic benefits. First, it enabled Allegiance to enter new markets with alacrity and reduce up-front capital requirements for entering individual markets prior to revenue generation. Second, in contrast to the traditional competitive local exchange carriers that generally built their networks in highly concentrated downtown areas due to the high cost of constructing fiber networks, Allegiance's business model enabled it to provide services to customers in downtown areas as well as the more geographically dispersed, less competitive areas of its targeted markets.

11. Allegiance's initial business plan proposed entering into 24 of the largest metropolitan areas in the United States. Subsequently, management expanded its business plan to (a) increase the total number of target markets to 36, (b) increase its service area, i.e., its colocation "footprint" in its original 24 markets, and (c) acquire long-term rights to use dark fiber rings to replace network elements leased by the Debtors from the incumbent local exchange carriers.

12. In addition to internal growth, Allegiance's business plan included growth through strategic acquisitions. For example, in December 2001, Allegiance acquired certain assets of Intermedia Business Internet (the "Intermedia Acquisition"). The Intermedia Acquisition enabled Allegiance to (a) become a Tier 1 Internet access provider, (b) provide large quantities of data transmitted at high-speeds over the Internet to and from a customer's premises, (c) efficiently exchange traffic with other Internet backbone providers giving Allegiance greater control over its Internet access, and (d)

leverage its local service presence to provide additional services to its target market. In June 2003, Allegiance acquired certain assets of Shared Technologies (the "Shared Technologies Acquisition"). The Shared Technologies Acquisition (a) added customer premises equipment sales, installation and maintenance to Allegiance's portfolio of integrated products and services, (b) strategically enhanced Allegiance's target market of small to medium size business enterprises, and (c) allowed Allegiance to provide a complete communications solution to business customers.

13. As of the date hereof, Allegiance provides its telecommunications services in major metropolitan areas across the United States, including the following 36 markets: Atlanta, Austin, Baltimore, Boston, Chicago, Cleveland, Dallas, Denver, Detroit, Fort Lauderdale, Fort Worth, Houston, Long Island, Los Angeles, Miami, Minneapolis/St. Paul, New York City, Northern New Jersey, Oakland, Ontario/Riverside, CA, Orange County, Philadelphia, Phoenix, Pittsburgh, Portland, Sacramento, St. Louis, San Antonio, San Diego, San Francisco, San Jose, Seattle, Tampa, Washington, D.C., West Palm Beach/Boca Raton and White Plains. Allegiance is colocated in 849 central offices and has a Tier 1 Internet backbone.

The FCC Recognizes the Importance of Allegiance

14. Federal policy recognizes the importance of facilities-based CLECs and Allegiance is the model. In that regard, the Federal Communications Commission (the "FCC") recently published its latest rules for local competition in the *FCC Triennial Review*. In reviewing these rules, a Kaufman Bros. Equity Research Report, dated March 4, 2003, stated that "*Allegiance is the blueprint for local competition proposed by the FCC*." In addition, Kevin J. Martin, Commissioner of the FCC has noted:

> Allegiance has focused on building a business that adheres to the letter of the Telecom Act while leveraging the entrepreneurial spirit of the law, as well. Today, Allegiance stands as a model of what Congress intended in 1996, and what we hope to achieve in the years ahead – new entrants that have the opportunity to continue to invest in infrastructure, bring innovation and offer new service offerings to consumers in local markets that are open to fair and robust competition.

Kevin J. Martin, Commissioner, F.C.C., Address to the Telecommunications Law Conference and the Texas Chapter of the Federal Communications Bar Association (March 7, 2002) (transcript available at www.fcc.gov/Speeches/Martin/2002/spkjm203.html).

15. Thus, it is clear that Allegiance, by focusing on an intelligent – well thought out business model – building its own network and offering its consumers innovative services, is an integral player in the telecommunications marketplace and a model for the nation's policy of promoting sustainable facilities-based competition in the local telecommunications arena. With an appropriate capital structure and a reduction in unnecessary costs, Allegiance believes it will be one of the most successful telecommunications companies in the United States.

Capital Structure of the Debtors

Capital Stock

16. Allegiance Telecom, Inc. has two classes of authorized stock: (a) 750,000,000 shares of common stock, with par value of $0.01 per share and (b) 1,000,000 shares of preferred stock, with par value of $0.01 per share. As of December 31, 2002, Allegiance Telecom, Inc. had (i) 124,830,110 shares of common stock issued and outstanding, with 295 registered holders and at least 20,000 beneficial owners, and (ii) no shares of preferred stock outstanding. Allegiance Telecom, Inc.'s common stock is publicly traded on the Nasdaq National Market under the symbol "ALGX."

17. Allegiance Telecom, Inc. owns 100% of the capital stock of Allegiance Telecom Company Worldwide ("ATCW"), and ATCW directly or indirectly owns 100% of the capital stock of each of the other Debtors.

Prepetition Notes

18. In 1998, Allegiance Telecom, Inc. issued two series of notes: (i) 11 3/4% Senior Discount Notes with a face value of $445 million, due on February 15, 2008 (the "Senior Discount Notes") and (ii) 12 7/8% Senior Notes with a face value of $205 million, due on May 15, 2008 (the "Senior Notes"). The Senior Discount Notes were issued under that certain Indenture, dated as of February 3, 1998, between Allegiance Telecom, Inc. and The Bank of New York, as Indenture Trustee. The Senior Notes were issued under that certain Indenture, dated as of July 7, 1998, between Allegiance Telecom, Inc. and The Bank of New York, as Indenture Trustee. Neither the Senior Discount Notes nor the Senior Notes are secured by any assets of the Debtors or guaranteed by any of the Debtors.

Prepetition Credit Agreement

19. Prior to the Commencement Date, ATCW entered into that certain Credit and Guaranty Agreement, dated as of February 15, 2000, as amended as of November 27, 2002 (the "Prepetition Credit Agreement"), among ATCW, as borrower; all of the other Debtors, as guarantors; Goldman Sachs Credit Partners L.P. ("Goldman Sachs"), as syndication agent and sole lead arranger; General Electric Capital Corporation ("GECC") (as successor to Toronto Dominion (Texas), Inc.), as administrative agent, BankBoston, N.A. ("BankBoston") and Morgan Stanley Senior Funding, Inc. ("Morgan Stanley"), as co-documentation agents; Goldman Sachs, GECC, BankBoston, Morgan Stanley, certain managing agents, and lenders party thereto from

time to time (collectively, the "Prepetition Lenders"). As of the Commencement Date, the amount outstanding under the Prepetition Credit Agreement was approximately $465.3 million. The Debtors have pledged substantially all of their assets as collateral under the Prepetition Credit Agreement, including (a) the capital stock of ATCW and (b) substantially all of the assets of ATCW and its direct and indirect subsidiaries, including the capital stock owned by ATCW in each of its Debtor subsidiaries. As of the Commencement Date, there were 27 Prepetition Lenders under the Prepetition Credit Agreement.

Events Leading to Chapter 11 Filing

20. The distressed economic environment in the United States that followed the economic boom of the late 1990s has had a global and adverse impact on the telecommunications industry. In the late 1990s, in an effort to finance operations and build their networks, telecommunications companies borrowed significant amounts of money from lenders and the public through the issuance of debt. The resulting significant indebtedness incurred by telecommunications companies, combined with poor economic conditions required many companies, including the Debtors, to focus on reducing their debt either through out of court restructurings or the chapter 11 process.

21. Many of Debtors' existing and potential customers have experienced their own financial difficulties, thereby decreasing customer demand for existing and new services. The financial difficulties of the Debtors' customers has led to non-payment, partial payment, or slow payment of bills for services provided by the Debtors. The financial instability of other companies in the telecommunications industry has adversely affected the willingness of potential customers to move their telecommunications services to the Debtors. In addition, certain of the Debtors' suppliers

have requested deposits, letters of credit, or other types of security. Moreover, telecommunications carriers that owe reciprocal and/or intercarrier compensation to the Debtors have either refused to pay or failed to pay in a timely manner for the services provided by the Debtors.

22. As a consequence of the foregoing, the Debtors' business operations were adversely impacted and, due to revenue trends and continuing negative EBITDA, the Debtors determined that their current level of indebtedness needed to be significantly reduced. Thus, in order to maximize the long-term wealth generating capacity of their business operations, the Debtors, among other things, (a) established a special restructuring committee of the Board of Directors of Allegiance Telecom, Inc., (b) retained restructuring advisors, and (c) commenced extensive negotiations with their senior lenders and bondholders, as detailed below.

Negotiations with the Prepetition Lenders and the Ad Hoc Committee of Bondholders

23. The Debtors, in the exercise of their sound business judgment - and in recognition of the distressed economic environment and the need for the Debtors' businesses to focus on profitability instead of high revenue growth - determined that a meaningful de-leveraging of their capital structure was crucial for the preservation and maximization of the value of their businesses. In that regard, the Debtors, in conjunction with their financial advisors and the Board of Directors of Allegiance Telecom, Inc., commenced the process of determining the appropriate capital structure for their business operations. After determining the appropriate capital structure, the Debtors commenced negotiations with the Prepetition Lenders and the Ad Hoc Committee (as defined below) to effectuate a restructuring transaction.

24. In October of 2002, Allegiance began negotiations with its Prepetition Lenders regarding a potential restructuring of its long-term debt. On November 27, 2003, Allegiance and its Prepetition Lenders entered into that certain First Amendment to the Prepetition Credit Agreement (the "Amendment"). Pursuant to the Amendment, the Debtors obtained a moratorium on their financial covenants through April 30, 2003. In exchange for the Amendment, Allegiance agreed, among other things, (a) that an event of default would occur on April 30, 2003 unless it reduced its long term debt to a level not to exceed $645 million, and (b) to repay $15 million to the Prepetition Lenders on account of debt owed under the Prepetition Credit Agreement. During the latter part of 2002 and to meet covenants under the Amendment, the Debtors significantly lowered their capital expenditures, reduced headcount, substantially decreased growth, eliminated less profitable products and services, and continued to optimize their existing network assets.

25. After entering into the Amendment, the Debtors commenced negotiations with the Prepetition Lenders to consummate a permanent restructuring. In connection with the negotiations regarding the permanent restructuring, the Debtors commenced negotiations with an *ad hoc* committee of noteholders, which is comprised of certain holders of the Senior Notes and the Senior Discount Notes (the "Ad Hoc Committee").

26. The Debtors, the Prepetition Lenders and the Ad Hoc Committee were not able to reach an agreement concerning the permanent restructuring prior to the April 30 deadline. On April 29, 2003, in order to avoid the occurrence of certain events of default under the Prepetition Credit Agreement, the Debtors and the Prepetition

Lenders entered into a forbearance agreement (the "Forbearance Agreement"), which expires on May 15, 2003. The Forbearance Agreement provided for, among other things, a pay down of $5 million of principal owed under the Prepetition Credit Agreement.

27. After entering into the Forbearance Agreement, the Debtors continued their negotiations with the Prepetition Lenders and the Ad Hoc Committee. However, the parties were unable to reach an agreement prior to the expiration of the term of the Forbearance Agreement. Consequently, the Debtors, in the exercise of their prudent business judgment, determined that it was in the best interests of all of their stakeholders and for the maximization of the value of their businesses to commence these chapter 11 cases and consummate a restructuring of their indebtedness under the auspices of this Court.

Relief Requested

28. By this Motion (the "Motion"), the Debtors seek the entry of an order (a) authorizing, but not requiring, the Debtors to pay prepetition sales and use taxes, and regulatory and universal service fees and such other similar taxes and fees as the Debtors, in their sole and absolute discretion, deem appropriate and necessary and (b) authorizing and directing applicable banks and other financial institutions to receive, process, honor and pay all checks presented for payment that were drawn in satisfaction of the prepetition amounts referenced herein.

Prepetition Sales and Use Taxes and Regulatory and Universal Service Fees

29. In connection with the normal operation of their businesses, the Debtors collect and remit an assortment of taxes to various federal, state, and local taxing authorities (the "Taxing Authorities"), including those Taxing Authorities listed in Exhibit "A" annexed hereto. The Debtors also pay various regulatory fees to federal,

state, and local regulatory authorities (the "Regulatory Authorities"), including those Regulatory Authorities listed in Exhibit "B" annexed hereto.

Sales Taxes

30. In the normal course of their business, the Debtors sell international, interstate, and intrastate telecommunication services and equipment to their customers. In connection with such sales, the Debtors collect and remit an assortment of sales, local gross receipts, and utility users taxes (collectively, the "Sales Taxes") to the Taxing Authorities. On a periodic basis — typically monthly — the Debtors remit the Sales Taxes collected during the preceding month to the Taxing Authorities. Some Taxing Authorities require the Debtors to prepay an estimated amount of Sales Taxes that the Debtors will collect in the coming month.

Use Taxes

31. The Debtors also are responsible for the payment of use taxes (the "Use Taxes") when they purchase any tangible personal property, including switches, routers, and other telecommunications-related equipment from vendors. The Use Taxes arise when the Debtors purchase equipment from a vendor in a state in which the vendor has no business operations. Without such nexus, the vendor is not obligated to charge or remit sales taxes for sales to parties within the state. Nevertheless, the purchasers, — i.e., the Debtors — are obligated to self-assess and pay the Use Taxes. The Debtors remit the Use Taxes to the Taxing Authorities on a monthly basis.

Federal Excise Taxes

32. The Debtors pay a three percent (3%) federal excise tax (the "Federal Excise Tax") on most intrastate and interstate telecommunication services. A

Federal Excise Tax return is filed with the relevant Taxing Authorities on a quarterly basis. The Debtors remit payment for such Federal Excise Taxes twice a month.

Municipal Franchise Fees

33. Some municipalities require the Debtors to collect and/or pay a municipal franchise fee (the "Municipal Franchise Fees") for providing service in the municipality. The basis for the calculation and the method of collection of Municipal Franchise Fees are based on gross billed revenue in the jurisdiction. In many instances, the Debtors collect the Municipal Franchise Fees as an agent for the Taxing Authorities, while in other instances the Debtors pass through the Municipal Franchise Fee to their customers.

34. As of the Commencement Date, the Debtors estimate that they owe approximately $7.22 million in Sales Taxes, Use Taxes, Federal Excise Taxes and Municipal Franchise Fees to the Taxing Authorities.

Gross Receipts Taxes

35. The District of Columbia, Maryland, New Mexico, New York, Ohio, Pennsylvania, Virginia and Washington impose a gross receipts tax (the "Gross Receipts Tax") on the Debtors' telecommunications services. The Gross Receipts Tax is assessed at a rate between 2% and 5% of the cost of the service, and the Debtors pass along this expense to their customers in the form of a surcharge. The Gross Receipts Tax is assessed annually on a calendar year basis, but paid quarterly through estimated payments that are due March on 15th, June 15th, September 15th and December 15th. The Debtors estimated that $225,000 in Gross Receipts will come due on June 15, 2003 for the period of January 1, 2003 through December 31, 2003. In addition, as of April 20, 2003, the Debtors did not owe any additional Gross Receipts Taxes for the year 2002.

Michigan Single Business Tax

36. The Debtors pay a state income tax in Michigan, which is known as the "Michigan Single Business Tax" (the "MSB Tax"). Michigan law imposes personal liability on the directors and officers of a corporation if that corporation fails to pay the MSB Tax. As the Commencement Date, the Debtors believe that they do not owe any MSB Tax. Nonetheless, out of an abundance of caution, the Debtors seek authority to pay any MSB Tax that is subsequently determined upon audit to be owed for periods prior to the Commencement Date.

Business License Fees

37. Many municipal and county governments require the Debtors to obtain a business license and to pay corresponding business license fees (the "Business License Fees"). The criteria requiring a company to obtain a business license and the manner that the business license fees are computed vary greatly according to the local tax laws. Some business license fees are based upon gross receipts derived from the local jurisdiction. Other business license fees are based on a flat fee or upon the number of employees working in the jurisdiction. The Debtors estimate that they pay approximately $160,000 annually in Business License Fees to the Taxing Authorities.

Regulatory Fees and Universal Service Fees

38. The Debtors pay regulatory fees (the "Regulatory Fees") and universal service fees (the "Universal Service Fees") to the Regulatory Authorities. The Regulatory Fees and Universal Service Fees are assessed as a percentage of the Debtors' revenues derived from the provision of telecommunication services within the jurisdiction of the relevant Regulatory Authority and remitted on a periodic basis depending on the payment requirements of the various Regulatory Authorities. The

Regulatory Fees are used to fund various federal and state agencies, while the Universal Service Fees are used to subsidize the high cost of local telecommunications services and other governmental program obligations such as telecommunications relay services. The Debtors estimate that they owe approximately $450,000 in Regulatory Fees and Universal Service Fees to the Regulatory Authorities for periods prior to the Commencement Date.

Method of Payment

39. As described above, the Debtors pay to the Taxing Authorities and the Regulatory Authorities (collectively, the "Taxing or Regulatory Authorities") Sales Taxes, Use Taxes, Gross Receipts Taxes, Federal Excise Taxes, MSB Taxes, and Municipal Franchise Fees (collectively, the "Sales and Use Taxes") and Business License Fees and Regulatory Fees and Universal Service Fees (collectively, the "Regulatory and Universal Service Fees") on a periodic basis with funds drawn by checks (the "Checks") or by means of electronic fund transfers (the "Electronic Transfers"). Prior to the Commencement Date, certain Taxing or Regulatory Authorities were sent Checks or Electronic Transfers in respect of such obligations that may not have cleared the Debtors' banks or other financial institutions (together, the "Banks") as of the Commencement Date.

40. The Debtors seek authority to pay all prepetition Sales and Use Taxes and Regulatory Fees owed to the Taxing or Regulatory Authorities, including all Sales and Use Taxes and Regulatory and Universal Service Fees subsequently determined upon audit to be owed for periods prior to the Commencement Date. To the extent any Check or Electronic Transfer has not cleared the Banks as of the Commencement Date, the Debtors request the Court to authorize and direct the Banks,

when requested by the Debtors in their sole discretion, to receive, process, honor, and pay such Checks or Electronic Transfers. To the extent the Taxing or Regulatory Authorities have otherwise not received payment for all prepetition Sales and Use Taxes and Regulatory and Universal Service Fees owed, the Debtors seek authorization to issue replacement checks, or to provide for other means of payment to the Taxing or Regulatory Authorities, to the extent necessary to pay all outstanding Sales and Use Taxes and Regulatory and Universal Service Fees owing for periods prior to the Commencement Date.

Cause Exists to Authorize the Debtors' Payment of
Prepetition Sales and Use Taxes and Regulatory Fees

41. Pursuant to sections 105(a), 363, and 541(d) of the Bankruptcy Code, the Debtors request (a) authorization to pay all prepetition Sales and Use Taxes and Regulatory and Universal Service Fees owed to the Taxing or Regulatory Authorities, including all Sales and Use Taxes and Regulatory and Universal Service Fees subsequently determined upon audit to be owed for periods prior to the Commencement Date, and (b) that the Court direct the Debtors' Banks to honor and process checks and transfers related to such relief.

42. Pursuant to section 105(a) of the Bankruptcy Code, the "court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). The Debtors submit that the relief requested herein is necessary and appropriate to carry out the provisions of the Bankruptcy Code.

43. Section 541(d) of the Bankruptcy Code provides, in relevant part, as follows:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an

> equitable interest . . . becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

11 U.S.C. § 541(d).

44. To the extent that the Debtors have collected Sales Taxes and Federal Excise Taxes from their customers, such funds are held in trust by the Debtors for the benefit of the Taxing Authorities and do not constitute property of the Debtors' estates. See, e.g., Begier v. Internal Revenue Service, 496 U.S. 53 (1990); In re Shank, 792 F.2d 829,830 (9th Cir. 1986) (sales taxes required by state law to be collected by sellers from their customers are "trust fund" taxes); DeChiaro v. New York State Tax Commission, 760 F.2d 432, 433 (2d Cir. 1985) (sales taxes are "trust fund" taxes); In re American Int'l Airways, Inc., 70 B.R. 102, 103 (Bankr. E.D. Pa. 1987) (excise and withholding taxes); In re Tap, Inc., 52 B.R. 271,272 (Bankr. D. Mass. 1985) (withholding taxes). Because the Sales Taxes and Federal Excise Taxes are not property of the Debtors' estates, these funds are not available for the satisfaction of creditors' claims.

45. In addition, Sales Taxes, Use Taxes, Federal Excise Taxes, Municipal Franchise Fees, and Gross Receipts Taxes are afforded priority status under section 507(a)(8) of the Bankruptcy Code. As priority claims, Sales Taxes, Use Taxes, Federal Excise Taxes, Municipal Franchise Fees, and Gross Receipts Taxes must be paid in full before any general unsecured obligations of a Debtor may be satisfied. The Debtors submit that sufficient assets exist to pay all prepetition Sales Taxes, Use Taxes, Federal Excise Taxes, Municipal Franchise Fees, and Gross Receipts Taxes in full under any plan or reorganization that may ultimately be proposed and confirmed by this Court. Accordingly, the proposed relief will only affect the timing — and not the amount — of

the payment of the prepetition Sales Taxes, Use Taxes, Federal Excise Taxes, Municipal Franchise Fees, and Gross Receipts Taxes, and, therefore, will not prejudice the rights of general unsecured creditors or other parties in interest.

46. The Regulatory and Universal Service Fees are also entitled to priority status under section 507(a)(8)(A), as "tax [as] . . . measured by income or gross receipts." Despite being labeled "fees," these expenditures fall within the category of taxes. For bankruptcy purposes, a tax is characterized as (a) an involuntary pecuniary burden, regardless of name, laid upon the individual or property; (b) imposed by, or under authority of the legislature; (c) for the public purposes, including the purposes of defraying expenses of government or undertakings authorized by it; and (d) under the police or taxing power of the state. LTV Steel Company, Inc. v. Shalala (In re Chateaugay Corp.), 53 F.3d 478, 498 (2d Cir. 1995) (citation omitted). The Regulatory Fees are both involuntary pecuniary burdens, generally imposed by the authority of a federal, state or local legislature under its police or taxing power and used for the public purposes of funding various federal and state agencies and subsidizing the high cost of local telecommunications services and other governmental support services. As a tax assessed as a percentage of the Debtors' revenue derived from the provision of telecommunication services within the jurisdiction of the relevant regulatory body, the Regulatory and Universal Service Fees qualify for a priority under section 507(a)(8) of the Bankruptcy Code. According to section 507(a)(8), the Regulatory and Universal Service Fees must be paid in full before any general unsecured obligations of a Debtor may be satisfied. Therefore, the proposed relief will only affect the timing of the

payment of the prepetition Regulatory Fees, and therefore, will not prejudice the rights of general unsecured creditors or other parties in interest.

47. Many federal and state statutes hold officers and directors of collecting entities personally liable for certain taxes owed by those entities. To the extent that any Sales Taxes, Use Taxes, Federal Excise Taxes, and MSB Taxes remain unpaid by the Debtors, the Debtors' directors and officers may be subject to lawsuits or criminal prosecution during the pendency of these chapter 11 cases. Any such lawsuit or criminal prosecution (and the ensuing potential liability) would distract the Debtors and their officers and directors from their attempt to implement a successful reorganization strategy, to the detriment of all parties in interest in these chapter 11 cases.

48. Payment of the Business License Fees and the Regulatory Fees is critical to the Debtors' operations. If the prepetition Business License Fees and Regulatory and Universal Service Fees are not paid, the Taxing or Regulatory Authorities could potentially challenge the applicability of the automatic stay under section 362(b)(4) of the Bankruptcy Code with concomitant expense to the Debtors' estate. See In re Fed. Communications Comm'n, 217 F.3d 125, 137 (2d Cir. 2000). In light of the de minimus amounts of Business License Fees and Regulatory and Universal Service Fees owed, the benefit to the Debtors for making these payments far outweighs their cost. Failing to pay all prepetition Business License Fees and Regulatory and Universal Service Fees may harm the Debtors to the detriment of the Debtors' estates, creditors, and all parties in interest.

49. In numerous chapter 11 cases, bankruptcy courts in this district have exercised their equitable powers under section 105 of the Bankruptcy Code to

authorize debtors to pay prepetition tax obligations. See, e.g., In re Adelphia Bus. Solutions, Inc., et al., Ch. 11 Case No. 02-41729 (REG) (Bankr. S.D.N.Y. 2002); In re Global Crossing Ltd., et al., Ch. 11 Case Nos. 02-40187 (REG) through 02-40241 (REG) (Bankr. S.D.N.Y. 2002); In re Enron Corp., Case No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2001); In re AI Realty Marketing of N.Y., Inc., Case Nos. 01-40252 through 01-40290 (AJG) (Bankr. S.D.N.Y. 2001); In re CWT Specialty Stores, Inc., Case No. 00-B-I0758 (JHG) (Bankr. S.D.N.Y. 2000); In re County Seat Stores, Inc., Case No. 99-10010 (CB) (Bankr. S.D.N.Y. 1999); In re Best Prods. Co., Inc., Case Nos. 91 B 10048 through 91 B 10053 (TLB) (Bankr. S.D.N.Y. 1991). The Debtors submit that the present circumstances warrant similar relief in these chapter 11 cases.

Payment of Checks Issued and Other Transfers
Made in Respect of Prepetition Sales and Use Taxes

50. The Debtors further request that all applicable Banks, a list of which is annexed hereto as Exhibit "C", be authorized and directed, when requested by the Debtors in their sole discretion, to receive, process, honor, and pay any and all Checks or Electronic Transfers drawn on the Debtors' accounts to pay all prepetition Sales and Use Taxes and Regulatory and Universal Service Fees owed to the Taxing or Regulatory Authorities whether those Checks were presented prior to or after the Commencement Date, and to make other transfers provided that sufficient funds are available in the applicable accounts to make such payments. The Debtors represent that each of these Checks or transfers can be readily identified as relating directly to the authorized payment of prepetition Sales and Use Taxes and Regulatory and Universal Service Fees. Accordingly, the Debtors believe that Checks and transfers other than those relating to authorized payments will not be honored inadvertently.

51. Nothing in this Motion should be construed as impairing the Debtors' right to contest the amount of any Sales and Use Taxes and Regulatory and Universal Service Fees that may be owed to any Taxing or Regulatory Authority, and the Debtors expressly reserve all of their rights with respect thereto.

Waiver of Memorandum of Law

52. Because there are no novel issues of law presented herein, the Debtors respectfully request that the Court waive the requirement that the Debtors file a memorandum of law in support of this Motion pursuant to rule 9013-1(b) of the Local Bankruptcy Rules for the Southern District of New York.

Notice

53. Notice of this Motion has been provided to: (a) the Office of the United States Trustee for the Southern District of New York; (b) attorneys for the Prepetition Lenders; and (c) attorneys for the Ad Hoc Committee. In light of the nature of the relief requested herein, the Debtors submit that no other or further notice is required.

No Prior Request

54. No prior motion for the relief requested herein has been made to this or any other Court.

WHEREFORE, the Debtors respectfully request entry of an order granting the relief requested herein and such other or further relief is just.

Dated: New York, New York
May 14, 2003

Respectfully submitted,

/s/ Matthew A. Cantor

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