

KIRKLAND & ELLIS LLP
Citigroup Center
153 East 53rd Street
New York, New York 10022-4675
Telephone: (212) 446-4800
Facsimile: (212) 446-4900
Matthew A. Cantor (MC-7727)
Jonathan S. Henes (JH-1979)
Lisa G. Laukitis (LG-9248)

Attorneys for Debtors and Debtors in Possession

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	X
	:	
Allegiance Telecom, Inc., <u>et al.</u> ,	:	Chapter 11 Case No.
	:	03-13057 (RDD)
	:	
Debtors.	:	Jointly Administered

**DEBTORS' REPLY TO OBJECTION OF LEVEL 3 COMMUNICATIONS LLC TO
DEBTORS' MOTION FOR APPROVAL OF BIDDING PROCEDURES AND
BID PROTECTIONS IN CONNECTION WITH THE SALE OF SUBSTANTIALLY
ALL OF THE ASSETS OF THE DEBTORS, AND APPROVING THE FORM
AND MANNER OF NOTICES IN CONNECTION THEREWITH**

TO: THE HONORABLE ROBERT D. DRAIN,
UNITED STATES BANKRUPTCY JUDGE:

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

The Objection

1. On January 6, 2004, Level 3 Communications, LLC ("Level 3") filed an objection (the "Objection") to the motion of Allegiance, dated December 18, 2003 (the "Motion"), for entry of, *inter alia*, an order (the "Bidding Procedures Order") pursuant to sections 105(a) and 363 of the Bankruptcy Code: (a) establishing bidding procedures and bid

protections (the “Bidding Procedures”) in connection with the sale of substantially all of the assets of the Debtors (the “Sale Assets”); (b) approving the form and manner of notices thereof; (c) approving the asset purchase agreement (the “Purchase Agreement”) executed on December 18, 2003 with Qwest Communications International, Inc. (“Qwest”) subject to higher and better offers; and (d) setting a hearing date to consider approval of the sale transaction (the “Sale Approval Hearing”).

Preliminary Statement

2. The main thrust of Level 3’s Objection is that the Debtors’ proposed Bidding Procedures are critically flawed because the “potential bidders and key stakeholders” have not been provided with the information necessary to make an informed decision relating to the Sale Assets or “market check” the fairness and reasonableness of the consideration to be received by the Debtors. The information the Debtors allegedly fail to provide relates to:

- the “INSPA” (as defined below) -- an executory contract between the Debtors and Level 3 that is not being sold under the Purchase Agreement, and
- a term sheet (set forth in Schedule 6.26 of the Disclosure Schedules) outlining the terms of a Master Service Agreement (as defined in the Purchase Agreement) between the Debtors and Qwest for the provision of services by Qwest to Allegiance relating to the Debtors’ obligations under the INSPA -- which, under the Purchase Agreement, if requested by the Debtors will be entered into by the Debtors and Qwest.

3. The arguments asserted by Level 3 with respect to the foregoing are premature and devoid of merit. As discussed below, Level 3 filed the Objection in an attempt to derail the sale process and gain leverage to pilfer benefits for itself at the expense of the Debtors’ estates. The simple, uncontroverted facts are:

- Level 3 takes the Hobson’s position that the proposed Bid Procedures are flawed because the Debtors have not disclosed the terms set forth in Schedule 6.26 of the Disclosure Schedules, while at the same time asserting that the INSPA cannot, as a matter of law, be assumed by the Debtors irrespective of such terms.

- The INSPA is not an Acquired Asset (as defined in the Purchase Agreement).
- Potential bidders, subject to their execution of an appropriate confidentiality agreement, may obtain a copy of Schedule 6.26 of the Disclosure Schedules and will have an opportunity to discuss the INSPA and related matters with Debtors as part of their due diligence.
- Level 3 has not presented any applicable authority supporting its Objection.
- A determination on whether the Debtors may provide adequate assurance of future performance under the INSPA in accordance with section 365(b)(1)(C) of the Bankruptcy Code is premature as the Debtors have not yet determined whether they will assume or reject the INSPA.
- The proposed Bidding Procedures are consistent with routinely approved procedures implemented by this Court and other bankruptcy courts. Moreover, in an effort to accommodate objections that have been made by other parties, the Debtors have modified the Bidding Procedures to (a) make it clear that third parties may bid for all or part of the Sale Assets, as well as for any Excluded Asset (such as the INSPA) and (b) clarify that a third party may, but is not required to, offer to enter into the Services Agreement.

4. The bottom line is that the Level 3 Objection is not an objection to the proposed Bidding Procedures at all; rather, it is an attempt to derail the Debtors' sale process. Level 3's Objection is not even relevant to the Sale Approval Hearing, much less to the discrete issues relating to the proposed Bidding Procedures that are now before the Court. Moreover, Level 3's entire pleading -- which is based on its purported concerns as to whether the Debtors (or Qwest) would be able to perform under the INSPA if the Debtors were to decide in the future to assume and assign it -- is disingenuous. That is because, as set forth below, for over a year Level 3 has employed one tactic after another, now including this Objection, designed to pressure the Debtors and disrupt their reorganization so that Level 3 can gain leverage and thereby buy its way out of, and terminate, the INSPA for a below-market price -- to the detriment of the Debtors and their creditors. That is the real purpose of the Objection, and Level 3 has not presented any authority or colorable reason as to why the Bidding Procedures Order should not be approved.

The Dispute With Level 3

5. Level 3's Objection is not a bona fide objection by an interested party, but rather is the continuation of a pattern of improper behavior by Level 3 that began almost fifteen months ago. This history exposes Level 3's motivations for filing the Objection. By way of background, in 1999, Genuity Solutions, Inc. ("Genuity"), a company that operated one of the original Tier 1 Internet backbones, was a party to a major contract with America Online ("AOL"), pursuant to which Genuity provided a substantial portion of AOL's dial-up network.

6. Notably, AOL does not own or operate all of the networks that its customers use to reach AOL's Internet service. Rather, AOL relies on other companies to provide the portion of its network used to interconnect with the public switched telephone network and the dial-up services to its subscribers. In that regard, when an AOL customer in a large city wants to connect to AOL, it dials a local phone number and the call connects to a bank of modems owned by a local exchange carrier, such as Allegiance. The call is then transported by an operator of data network, such as Genuity, to AOL's data network. Because Genuity operated only a data network, was not certified as a local exchange carrier and did not operate its own local network, it needed to enter into subcontracts with local exchange carriers that could provide interconnection with the public switched telephone network. Originally, Genuity purchased only local exchange service from Allegiance and provided its own modems. Subsequently, in July 2000, Genuity and Allegiance entered into the Integrated Network Solution

Purchase Agreement(the “INSPA”), pursuant to which Allegiance agreed to provide Genuity with local exchange services as well as modems.¹

7. The services provided under the INSPA generally are measured by, among other things, the number of modem ports provided by Allegiance to Genuity (or, currently, Level 3). Pursuant to the INSPA, Allegiance initially provided Genuity with approximately 240,000 ports. However, in late 2001, Genuity decided to reduce the number of local exchange carriers with which it was subcontracting. Specifically, Genuity wanted to subcontract only with companies, such as Allegiance, that had consistently met the performance standards required by Genuity. As a result, Genuity and Allegiance amended the INSPA to increase the number of ports provided by Allegiance from approximately 240,000 to approximately 470,000. This dramatically expanded Allegiance’s business with Genuity and, as a result, Allegiance subcontracted a portion of the local exchange services for modems provided to Genuity from KMC Telecom, another local exchange carrier.²

8. In the second half of 2002, Genuity experienced financial difficulties and eventually filed for bankruptcy. The main objective of the bankruptcy was to sell substantially all of Genuity’s assets to a third party. In that regard, Genuity sold its assets, which included an assignment of the INSPA, to Level 3.

9. The assignment of the INSPA, however, posed a major problem for Level 3. Level 3, as noted above, has its own local network capabilities and, as a result, does not need

¹ AOL had network providers other than Genuity. For example, Level 3 and UUNet (which was part of MCI) provide local exchange and modem services to AOL. Level 3 and UUNet have their own local exchange networks. Thus, unlike Genuity, they do not need to subcontract with local exchange carriers.

² The services provided by KMC are essentially the connectivity from the public switched telephone network to the banks of modems. This is essentially the same services that Allegiance seeks to have Qwest provide to Allegiance post-Closing under Schedule 6.26 of the Asset Purchase Agreement.

to subcontract with local exchange carriers such as Allegiance to provide services to AOL or others. In other words, Level 3 did not need the INSPA. Accordingly, prior to executing an agreement to acquire Genuity, Level 3 approached Allegiance and sought to intimidate Allegiance into agreeing to substantially change the INSPA by, among other things, reducing the scope of the INSPA. In particular, Level 3 threatened that if Allegiance did not agree to the reductions, then Level 3 would seek to have the INSPA rejected in Genuity's bankruptcy.

10. Allegiance, after extensive negotiations with Level 3, ultimately decided that it would not agree to the changes sought by Level 3 to the INSPA. The threat of the rejection of the INSPA was empty as it would have created a significant claim which would have caused Genuity's creditor constituencies to oppose the sale of Genuity's assets to Level 3. Thus, Level 3 abandoned its efforts to renegotiate or cause rejection of the INSPA and instead sought Allegiance's support of Level 3's acquisition of Genuity. In particular, Level 3's senior officers sought a public statement in a press release from Allegiance's Chairman and Chief Executive Officer in support of the sale transaction. Allegiance ultimately agreed to this request in reliance on promises made by Level 3 and these senior officers that Level 3 was committed to refrain from taking actions with respect to the INSPA that would not result in a "win-win" situation for both parties.

11. In February 2003, Level 3 consummated its purchase of the Genuity business, including the INSPA. Immediately after the announcement of the Genuity sale transaction, Level 3 was questioned by financial analysts as to why its profit margins on the Genuity business were so much lower than its profit margins on its other modem business with AOL. The answer was that the INSPA significantly cut into those margins, a situation that Level 3 found undesirable.

12. As soon as Level 3 had consummated its purchase of Genuity, Level 3 -- despite its commitments to the contrary -- resumed its actions to terminate or modify the INSPA by asserting erroneously that Allegiance's performance did not meet the required standards thereunder. Notwithstanding these assertions, Level 3 was unable to provide Allegiance with the supporting data necessary to demonstrate that Allegiance's performance did not meet the requirements of the INSPA, Level 3 was unable to provide any data as required by the INSPA. At that same time, Allegiance was in discussions with its pre-petition senior secured lenders to negotiate a permanent capital restructuring. Once again, Allegiance negotiated with Level 3, but was unable to reach an amicable amendment to the INSPA.

13. Notwithstanding Level 3's baseless allegations, Level 3 continued to make most of the required payments to Allegiance under the INSPA, while reserving its rights each time. Level 3's baseless claims had a material adverse impact on Allegiance. Specifically, Allegiance was required to disclose in its SEC filings that Level 3 -- Allegiance's largest customer -- was threatening to terminate the INSPA for poor performance. These threats and the required disclosures in early 2003 severely hampered Allegiance's ability to restructure outside of bankruptcy and contributed to the commencement of Allegiance's chapter 11 cases with this Court.

14. During these chapter 11 cases, Level 3 has continued its pattern of harassing Allegiance and interfering with its reorganization efforts. Notably, in the final week of November 2003, as Allegiance was seeking to complete its negotiations with Qwest, Level 3 -- aware of the negotiations -- threatened litigation against Allegiance unless Allegiance immediately sold the INSPA to Level 3 for an unreasonably low price, thereby depriving Allegiance of an important asset prior to its auction and related sale transaction. As a result of

Level 3's coercive tactics and, based on the litigation threats (which were a continuation of those made throughout these chapter 11 cases), the negotiations between Allegiance and Qwest were derailed.

15. In December of 2003, after significant efforts by Allegiance to bring Qwest back to the negotiating table, Qwest and Allegiance were able to reach a definitive agreement regarding a stalking horse bid. In that regard, Qwest and Allegiance agreed that, given Level 3's actions, they had no choice but to exclude the INSPA from the sale transaction.

16. Nonetheless, these efforts by Level 3 may depress the value that Allegiance ultimately receives as part of the sale either by deterring other bidders or decreasing the value that bidders are willing to pay as a result of the uncertainty being created by Level 3. Allegiance cannot allow this interference to continue and is prepared to pursue its rights to recover the full measure of damages caused by Level 3 and its officers and directors. If past is prologue, this Court can be assured that a litany of Level 3 objections to other motions filed by the Debtors in these chapter 11 cases will follow in an attempt to further impede the Debtors' sale and plan confirmation process.

The Objection Should Be Overruled

Level 3's Objection With Respect to the Assumption and Assignment of the INSPA is Premature

17. In the Objection, Level 3 asserts that even if the information regarding the terms of the servicing agreement is provided, Level 3 must consent to the transfer of the "servicing duties" prior to or at the auction. This assertion ignores the facts and is devoid of legal support. The facts are simple: (a) the INSPA is not being assigned to Qwest, (b) the Debtors have not determined whether the INSPA should be assumed or rejected in these chapter 11 cases or whether to assume and assign the INSPA to a third party, and (c) if the Debtors determine that the assumption of the INSPA is in the best interests of the estates, then Qwest has

agreed to enter into a servicing agreement with the Debtors. If the Debtors determine to assume the INSPA, it is clear that they will need to demonstrate adequate assurance of future performance thereof under section 365(b) of the Bankruptcy Code. However, as that decision has not been made, Level 3's argument that its consent is necessary to the sale is groundless.³ Unambiguously, Level 3's consent is not necessary and the Objection, as it relates thereto, should be overruled.

Schedule 6.26 of the Disclosure Schedules Can Be Obtained By Any Interested Party

18. Level 3 complains that it has not been given Schedule 6.26 of the Disclosure Schedules. Schedule 6.26 of the Disclosure Schedules sets forth the specific terms under which the INSPA could be serviced by Allegiance following the sale of the Debtors' assets to Qwest. Level 3 asserts that the failure to disclose Schedule 6.26 of the Disclosure Schedules precludes the ability of interested bidders for the Debtors assets and other parties in interest to assess the total value of Qwest's bid or determine what would constitute a higher and better offer for the Sale Assets. This Objection is contrived and ignores the facts.

19. The Motion states that "[c]ertain annexes and schedules to the Purchase Agreement, as well as ancillary agreements related to the Purchase Agreement, are not annexed hereto because such documents contain confidential financial and/or competitive information. Parties interested in obtaining copies of such documents should contact the attorneys for the Debtors." See Motion at 8, n. 2. Clearly, if any interested party desires a copy of Schedule 6.26 of the Disclosure Schedules, it is required only to contact the Debtors' attorneys and execute an

³ Remarkably, Level 3 asserts in the Objection that it is "impossible" for the Debtors to assume the INSPA. See Objection, para. 12.

appropriate confidentiality agreement. Accordingly, the Objection, as it relates to the foregoing, is misleading and should be overruled with prejudice.

Conclusion

The Objection has no merit and was filed in order to interfere with the Debtors' assets and gain an unfair bargaining advantage in Level 3's dispute with the Debtors.

Accordingly, the Debtors respectfully request that the Court overrule the Objection, grant the relief requested in the Motion and such other and further relief as the Court may deem just and appropriate.

Dated: New York, New York
January 8, 2004

Respectfully submitted,

/s/ Matthew A. Cantor

Matthew A. Cantor (MC-7727)

Jonathan S. Henes (JH-1979)

Lisa G. Laukitis (LG-9248)

KIRKLAND & ELLIS LLP

Citigroup Center

153 East 53rd Street

New York, New York 10022-4675

Telephone: (212) 446-4800

Facsimile: (212) 446-4900

Attorneys for Debtors and Debtors in Possession