Hearing Date: April 16, 2004, at 10:00 a.m.
Objection Deadline: April 13, 2004, at 4:00 p.m.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
ALLEGIANCE TELECOM, INC., et al.,	:	Case No. 03-13057 (RDD)
Debtors.	:	(Jointly Administered)

OBJECTION OF THE TELEPHONE OPERATING COMPANY SUBSIDIARIES OF VERIZON COMMUNICATIONS INC. TO DEBTORS' MOTION FOR AN ORDER (I) APPROVING THE DISCLOSURE STATEMENT; (II) ESTABLISHING A RECORD DATE; (III) APPROVING SOLICITATION PACKAGES AND PROCEDURES FOR DISTRIBUTION THEREOF; (IV) APPROVING FORMS OF BALLOTS AND ESTABLISHING PROCEDURES FOR VOTING ON THE PLAN; AND (V) ESTABLISHING NOTICE AND OBJECTION PROCEDURES FOR CONFIRMATION OF THE PLAN

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

The telephone operating company subsidiaries of Verizon Communications Inc. (collectively, "Verizon"), by and through their undersigned counsel, hereby object (the "Objection") to the above-captioned motion of the Debtors, dated March 18, 2004 (the "Motion"). In particular, Verizon objects to the Debtors' requests for approval of the Debtors' proposed disclosure statement ("Disclosure Statement") and for authority to begin soliciting

acceptances of the Debtors' proposed plan ("Plan").[1] As described below, that Plan inherently violates the Bankruptcy Code and is unconfirmable on its face. Moreover, the Disclosure Statement fails to provide adequate information about several critical aspects of the Plan.

BACKGROUND

1. On May 14, 2003, Allegiance Telecom, Inc. and certain of its subsidiaries (collectively, the "Debtors") filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). Pursuant to sections 1107(a) and 1108 of the Bankruptcy Code, the Debtors continue to operate their businesses and manage their affairs as debtors-in-possession.

2. The Debtors are competitive local exchange carriers ("CLECs") that rely upon existing or "incumbent" local exchange carriers ("ILECs") as critical wholesale service providers supporting the Debtors' CLEC business. Verizon is one such ILEC. The Debtors use the telecommunications services furnished by Verizon not only for their own communications needs, but as a critical component of the Debtors' own telecommunications business. Indeed, the Debtors have acknowledged that their ability to continue in business and provide telecommunications services to their end user customers is "dependant" upon the services they obtain from Verizon and other telecommunications providers. Motion of the Debtors Pursuant to §§ 105(a) and 366 of the Bankruptcy Code for an Order Deeming the Utilities Adequately Assured of Future Performance and Establishing Procedures for Determining Requests for Additional Adequate Assurance, dated May 14, 2003, ¶ 39. The Debtors have also admitted that

[1] Capitalized terms not otherwise defined in this Objection shall have the meanings given to them in the Plan.

Verizon is their most significant provider of telecommunications services and their largest trade creditor. In the list of their 20 largest unsecured creditors filed at the outset of these cases, the Debtors included only one trade creditor (the rest of the creditors listed were bondholders or banks): Verizon.

3. In fact, as reflected in Verizon's prepetition proof of claim filed in these cases, Verizon is owed more than $61 million by the Debtors on account of the Debtors' repeated, large defaults under their various executory contracts with Verizon. Under Section 365 of the Bankruptcy Code, these defaults must be cured in full before the Debtors may assume, or assume and assign, those contracts.

4. On February 20, 2004, this Bankruptcy Court entered an order approving the sale to XO Communications, Inc. ("XO") of (i) substantially all of the assets of Allegiance Telecom, Inc. ("ATI") and Allegiance Telecom Company Worldwide ("ATCW") and (ii) the stock of the reorganized subsidiaries of ATCW, other than Shared Technologies Allegiance, Inc. Order (I) Approving the Sale Free and Clear of Liens, Claims and Encumbrances to the Successful Bidder, (II) Authorizing the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases, and (III) Granting Related Relief", at 4 (¶ F) (the "Sale Order"). In the Sale Order, this Court made clear that, in order for XO to obtain (directly or indirectly) the benefits of any of the executory contracts of the Debtors, it would have to do what every other buyer of the business of a debtor must do: have the debtor assume the contracts, cure all defaults, provide adequate assurance of future performance, and (if the buyer itself is to obtain the contracts) assign the contracts to the buyer. Thus, the Court specified that any assumption and/or assignment of any of the Debtors' contracts could occur only if "the requirements of section 365 of the Bankruptcy Code are satisfied." Sale Order at 11 (¶ 12). And the Court also directed that "[a]ll defaults or

other obligations of the Debtors under the Assumed Contracts . . . shall be promptly cured by the Debtors or Buyer as set forth in the Purchase Agreement as provided in section 365(b)(1) of the Bankruptcy Code . . . ." *Id.* at 12 (¶ 15).[2]

5. On March 18, 2004, the Debtors filed their Plan and the related Disclosure Statement. In their Motion, the Debtors seek, among other things, this Bankruptcy Court's approval of the Disclosure Statement and permission to begin soliciting acceptances of the Plan.

OBJECTIONS

6. This Bankruptcy Court should not approve the Disclosure Statement, or allow the Debtors to begin soliciting acceptances of the Plan, for two reasons. First, the Plan, which the Disclosure Statement describes, plainly violates several provisions of the Bankruptcy Code and is thus unconfirmable as a matter of law.[3] Second, the Disclosure Statement does not contain adequate information, as required by Section 1125 of the Bankruptcy Code, with respect to

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[2] This Court also made clear that the rights of Verizon and other ILECs, including their right to insist on a full cure of all amounts owed to them, were to be fully preserved:

> Notwithstanding any of the foregoing, or anything else to the contrary contained in this Order, the Purchase Agreement or any documents executed therewith, nothing in this Order, the Purchase Agreement or any documents executed therewith shall be deemed to affect the rights of any ILECs, as to any executory contracts or unexpired leases, to object, respond or otherwise be heard with respect to (without limitation) . . . (b) the assumption and assignment of any such executory contract or unexpired lease to the Buyer . . . and (d) the amount and timing of any cure and payments proposed by the Debtors . . . . All rights of the ILECs and the Debtors, with respect to the matters relating to executory contracts, are hereby fully reserved.

Id. at 15 (¶ 20).

[3] This Objection describes some of the provisions of the Plan that are most obviously contrary to the terms of the Bankruptcy Code. Verizon, of course, reserves the right, in connection with any confirmation hearing, to raise any and all additional objections to the Plan.

several central aspects of the Plan. More specifically, as described below, the Plan is unconfirmable because it violates several provisions of the Bankruptcy Code concerning executory contracts and the provision of utility services to the Debtors, and contains a purported "settlement" with the ATI Note Trustees that violates the absolute priority rule and appears on its face utterly devoid of any legal basis. In addition, also as described below, the Disclosure Statement does not contain adequate information about either the treatment of executory contracts (and, in particular, the treatment of ILECs and other providers of telecommunications services to the Debtors), or the proposed "settlement" with the ATI Note Trustees which will, it appears, cost the Debtors' unsecured trade creditors tens, if not hundreds, of millions of dollars.

I. The Disclosure Statement Describes a Plan That Is Unconfirmable.

A. The Plan Violates Sections 365 and 366.

7. The Disclosure Statement should not be approved because the Plan it describes is unconfirmable as a matter of law. "If the Court can determine from a reading of the plan that it does not comply with § 1129 of the Bankruptcy Code, then it is incumbent upon the Court to decline approval of the disclosure statement and prevent diminution of the estate." *In re Pecht*, 57 B.R. 137, 139 (Bankr. E.D. Va. 1986). Numerous other cases recognize this fundamental principle of bankruptcy law. *See, e.g., In re Dakota Rail, Inc.*, 104 B.R. 138, 143 (Bankr. D. Minn. 1989); *In re Copy Crafters Quickprint, Inc.*, 92 B.R. 973, 980 (Bankr. N.D.N.Y. 1988); *In re 266 Washington Assocs.*, 141 B.R. 275, 288 (Bankr. E.D.N.Y. 1992); *In re Eastern Maine Elec. Coop., Inc.*, 125 B.R. 329, 333 (Bankr. D. Me. 1991).

8. This Plan is unconfirmable is several material respects. First, it seeks to override Sections 365 and 366 of the Bankruptcy Code. It is black-letter law, clear from the language of

the Bankruptcy Code, that a debtor that wishes to retain (or assign to a buyer) its contract rights must assume those contracts by no later than the confirmation of any plan and must, to so assume such contracts, cure any defaults thereunder. Thus, Section 365 specifies both that "[i]n a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract … of the debtor at any time before the confirmation of a plan" and that, "[i]f there has been a default in an executory contract . . ., the trustee may not assume such contract . . . unless, at the time of assumption of such contract . . ., the trustee . . . cures, or provides adequate assurance that the trustee will promptly cure, such default . . ." 11 U.S.C. §§ 365(d)(2) and 365(b)(1)(A). The Plan violates these absolute requirements of the Bankruptcy Code because it purports to allow the Debtors and other parties to receive the benefits of executory contracts after the Plan's Initial Effective Date without requiring the Debtors to assume such contracts and cure any defaults. The Plan therefore cannot be confirmed. 11 U.S.C. § 1129(a)(1) (a plan may be confirmed "only if . . . [t]he plan complies with the applicable provisions of this title").

9. Specifically, the Plan purports to compel Verizon, and all other ILECs who are counter-parties to executory telecommunications services contracts, to continue providing services thereunder, following confirmation, to the Debtors, Reorganized STFI, the Reorganized Subsidiaries, and the Buyer, regardless of whether the Debtors assume any of those contracts and cure any of the defaults thereunder. The Plan does so through a variety of provisions.

10. At the outset, without any legal basis for doing so, the Plan purports to declare that certain services are not provided pursuant to an executory contract, so as to enable the Debtors to avoid the requirements of Section 365 and this Court's Sale Order. Thus, the Plan defines "Tariff Services" as:

> telecommunications services required to be provided by an Access Provider pursuant to a Tariff filed by such Access Provider with the Federal Communications Commission or relevant state commission. *For purposes of the Plan, the obligation of an Access Provider to provide Tariff Services does not arise under an executory contract*.

Plan § 1.117 (emphasis added).[4] There is no basis in law for this provision. As described below, tariffed services are plainly provided pursuant to executory contracts. But, whether or not the Debtors dispute that assertion, one thing is for certain: this Court, not the Debtors themselves, gets to decide the question. A debtor cannot magically brush aside the requirements of Section 365 by simply asserting that services are not provided pursuant to an executory contract. What is and is not an executory contract is a matter of law. The Bankruptcy Code does not allow a debtor unilaterally to decide this issue – any more than a debtor can decide on its own what is and is not a priority claim under Section 507, what is and is not required for confirmation of a plan, or any other matter affecting the rights of third parties.

11. The Debtors compound this problem in Section 6.3 of the Plan. That section makes clear the Debtors' intent: to obtain the benefit for themselves, the reorganized entities and XO of the continued provision of tariffed services without assuming the burden inherent in Section 365 – the requirement that the debtor cure all defaults. Thus, Section 6.3 provides:

> After the Initial Effective Date, all Access Providers shall continue to provide to the Debtors, Reorganized STFI, the Buyer or the Reorganized Subsidiaries, as the case may be, without interruption all Tariff Services, specifically including usage-sensitive access services, provided to the Debtors prior to the Initial Effective Date. Access Providers shall not be entitled to request any additional deposits or other financial security from

[4] The Plan defines "Tariff" as "the schedule of terms, conditions, and prices (a) which are filed with an appropriate regulatory commission or (b) which are made generally available to the public (or such classes of customers as to be effectively available directly to the public) for the provision of products and services." Plan § 1.116.

> the Debtors, Reorganized STFI, the Reorganized Subsidiaries or Buyer as a result of, arising out of, or in connection with, the Chapter 11 Cases. Any Claim against a Debtor by an Access Provider (or a Holder of a Claim of an Access Provider) for the provision of Tariff Services to such Debtor prior to the Commencement Date shall be deemed to be an ATCW Unsecured Claim and shall be treated in accordance with Section 3.4 hereof [general unsecured ATCW claims]. The Buyer shall have standing with respect to Claims arising out of Tariff Services.

12. The Plan thus seemingly requires "Access Providers," such as Verizon,[5] to continue post-confirmation, apparently forever, to provide services to not only the Debtors, but the reorganized entities and XO, without any assumption, assignment or cure of defaults. In this critical respect, the Plan plainly violates the Bankruptcy Code.

13. Contrary to the Debtors' bald assertion, tariffed services are provided pursuant to executory contracts. First, tariffs are commonly incorporated by reference as part of interconnection and other agreements that are unquestionably executory contracts. Second, even where that is not the case, services provided pursuant to a tariff are subject to an executory contract; the governing contractual terms are embodied in the tariff, and the contract for particular tariffed arrangements is created by the submission and acceptance of a tariff service order and remains executory in nature until a disconnection order is properly issued and processed and the contract is rejected. Numerous cases so hold. *See*, *e.g.*, *Cahnmann v. Sprint Corp.*, 133 F.3d 484, 487 (7th Cir. 1998) ("The terms and conditions of service are set forth in 'tariffs,' which are essentially offers to sell on specified terms, filed with the FCC and subject to modification or disapproval by it. . . . What this means is that the filed tariff is the contract

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[5] The Plan defines an "Access Provider" as "an Entity providing telecommunications services to the Debtors pursuant to an executory contract or a Tariff filed by such Entity with the Federal Communications Commission or a relevant state commission." Plan § 1.1.

between the [customer] and [the utility]."); *Biddle v. Mountain States Tel. & Tel. Co.*, 629 F.2d 571, 572 (9th Cir. 1980) ("the written tariffs on file with the Arizona Corporations Commission form only a part of the contract for telephone services. The contract between the parties did not arise until… requests for telephone services were made and Mountain Bell … agreed to supply them."); *MCI Telecomms. Corp. v. TCI Mail, Inc.*, 772 F. Supp. 64, 66 (D.R.I. 1991) ("MCI's contractual relationships with its customers are governed by MCI Tariff FCC No. 1."); *see also* 64 Am. Jur. 2d *Public Utilities* § 61 (2003) ("A tariff that has been approved by a public service commission becomes law and has the same force and effect as a statute enacted by the legislature; it amounts to a binding contract between the utility and its customer[.]"); 86 C.J.S. *Telecommunications* § 73 (2003) ("Generally, a tariff is to be viewed as a contract between the company and its customers, affirmed, on behalf of the customers, by the public service commission.").

14. It is also clear that these contracts are executory. An executory contract is a contract "under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." *TTS, Inc. v. Citibank, N.A. (In re TTS, Inc.)*, 158 B.R. 583, 588 (D. Del. 1993) (internal quotation marks and citation omitted). That is precisely the situation here. Verizon (or another Access Provider) has the continuing obligation to provide the Debtors with access to the network service arrangements, and the Debtors have the continuing obligation to pay for the use of those service arrangements, unless and until the Debtors issue proper cancellation orders and reject the executory contract. There is thus no basis in law for the Plan's definition of "Tariff Services," or for the requirement in Section 6.3 of the Plan that Verizon and other Access Providers continue to provide post-confirmation Tariff

Services to the Debtors, the reorganized entities and XO even though any claims arising under the relevant contracts will be treated as general unsecured claims and not cured. The Plan violates Section 365 of the Bankruptcy Code by mandating that ILECs such as Verizon provide executory contract services *after* confirmation of the Plan without any assumption of the contracts pursuant to which the services are provided and the cure of all defaults.

15. The Plan likewise violates Section 365 of the Bankruptcy Code with respect to the interconnection agreements between Verizon and the Debtors – agreements that are unquestionably executory contracts.[6] Section 6.2 of the Plan provides:

> After the Initial Effective Date, all Utility Companies shall continue to provide to the Debtors, Reorganized STFI, the Reorganized Subsidiaries or Buyer without interruption all Utility Services provided to the Debtors prior to the Initial Effective Date whether such Utility Services were provided pursuant to a contract or Tariff. Utility Companies shall not be entitled to request any additional deposits or other financial security from the Debtors, Reorganized STFI, the Reorganized Subsidiaries or Buyer as a result of, arising out of, or in connection with, the Chapter 11 Cases. Any Claim against a Debtor by a Utility Company (or a Holder of a Claim of a Utility Company) for the provision of Utility Services to such Debtor prior the Commencement Date shall be deemed to be an ATCW Unsecured Claim and shall be treated in accordance with Section 3.4

[6] The Bankruptcy Code does not define the term "executory contract," but, as noted, the most accepted definition is that of Professor Countryman: "An executory contract is a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 509-510 (Bankr. D. Del. 2003) (internal quotation marks and citation omitted). This describes perfectly the nature of the interconnection agreements to which Verizon and the Debtors are parties. If, under a particular interconnection agreement, either Verizon stopped providing telecommunications services, or the Debtors stopped paying for them, then that party would be in material breach of the interconnection agreement.

> hereof [general unsecured ATCW claims]. The Buyer shall have standing with respect to Claims arising out of Utility Services."[7]

The Debtors' clear intent is to require Verizon and other ILECs to continue to provide services under interconnection agreements and other executory contracts after the Plan goes effective, not only to the Debtors and the reorganized entities, but also to XO as well, even though the Debtors apparently will not cure any defaults under those contracts. Indeed, the only material difference between Section 6.2 and Section 6.3 is that the former expressly applies not only to Tariff Services, but also to all "Utility Services" – "whether such Utility Services were provided pursuant to a contract or Tariff." Plan § 6.2.

16. Section 6.2 clearly violates the Bankruptcy Code. There is one and only one way for a debtor to require a counter-party to an executory contract to continue to provide those services (whether to the debtor, as reorganized, or to a buyer of the debtor's assets, such as XO) after confirmation of the plan: the debtor must assume the contract and cure all defaults thereunder. 11 U.S.C. § 365(b). There is no legal basis for the Debtors (or the reorganized entities or XO) to continue to receive the benefits of Verizon's executory contracts after confirmation without first assuming those agreements and curing all defaults.

17. In addition to violating Section 365, the Plan also violates Section 366, of the Bankruptcy Code. First, the Plan purports to extend the protections of Section 366 to parties

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[7] The Plan defines a "Utility Company' as "a Person who provides Utility Services to Debtors, including, but not limited to, those Persons defined as Utility Companies in the Utilities Order." Plan § 1.125. In turn, the Plan defines "Utility Services" as "those services generally provided by utility providers and telecommunications vendors pursuant to a Tariff requested by the Debtors via a Utility Service Order, including, but not limited, to electricity, gas, water, telephone, telecommunications, Utility Services as defined in the Utilities Order, and other utility services." *Id.* § 1.127.

which have no statutory entitlement to them, namely, Reorganized STFI, the Reorganized Subsidiaries and the Buyer. Section 366 provides, in pertinent part, that "a utility may not alter, refuse, or discontinue service to, or discriminate against, *the trustee or the debtor* solely on the basis of the commencement of a case under this title or that a debt owed by the debtor to such utility for service rendered before the order for relief was not paid when due." 11 U.S.C. § 366(a) (emphasis added). By its terms, this section protects *only* the trustee and the debtor; no other party in interest may avail itself of Section 366's protections. Insofar as the Plan mandates the provision of Utility Services to Reorganized STFI, the Reorganized Subsidiaries and the Buyer, it violates Section 366.

18. Second, Section 366 is not designed to extend beyond a plan's effective date. It certainly does not apply forever indefinitely even after the debtor has emerged from bankruptcy. Section 366, like all other provisions to chapter 3 of the Bankruptcy Code, apply only to a pending case. 11 U.S.C. § 103(a). Moreover, its bar against the termination of service is akin to the automatic stay under § 362, which expressly remains in effect only until confirmation of a plan discharging (or failing to discharge) the debtor. 11 U.S.C. § 362(c)(2)(C). And reading Section 366 to require Verizon or another ILEC to continue, after confirmation of a plan, to provide telecommunications services pursuant to a tariff, interconnection agreement, or other executory contract would render Section 365, and its requirement that a debtor must, by no later than confirmation, assume any such contract and cure all defaults if it wants continued service, a nullity. Such an interpretation of Section 366 would thus violate the basic rule of statutory construction that, wherever possible, two different provisions of a statute must be interpreted in a way that nullifies neither and, instead, gives effect to both. *See*, *e.g.*, *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) ("It is a cardinal principle of statutory construction that a statute ought, upon

the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void or insignificant.") (internal quotation marks and citations omitted). In any event, the stipulation between Verizon and the Debtors concerning adequate assurance of future payment for telecommunications services, which was approved by this Court and filed under seal (at docket no. 585), terminates by its terms on the effective date of a chapter 11 plan without any further order of the Court. Accordingly, the Debtors have no basis to compel Verizon to provide services after the Plan goes effective, unless they assume the relevant contracts and cure any defaults thereunder.

19. Finally, by its terms, Section 366 only bars a utility from altering, refusing or discontinuing service to a debtor if the "sole[]" reason for the utility to do so is "the commencement of [the debtor's bankruptcy] case . . . or that a debt owed by the debtor to such utility for service rendered before the order for relief was not paid when due." 11 U.S.C. § 366(a). Section 366 does not bar a utility from altering, refusing or discontinuing service for any other reason. Verizon's interconnection agreements and tariffs allow it, in accordance with applicable non-bankruptcy law, to (among other things) demand deposits and other assurances of payment as appropriate. The Plan violates Section 366 and denies Verizon its legal rights by purporting to bar Verizon – apparently forever regardless of any deterioration in the financial stability of the reorganized entities or XO – from demanding "any additional deposits or other financial security" from those reorganized entities or XO. Plan §§ 6.2 and 6.3. These provisions of the Plan also violate Section 365 which requires that a debtor that wishes to continue to obtain for itself or a buyer the benefits of further service under an executory contract must not only cure all defaults, but also provide adequate assurance of future performance. 11 U.S.C. §§ 365(b)(1)(C) and 365(f)(2)(B).

20. In short, the Plan is plainly not confirmable on its face because it violates both Sections 365 and 366 of the Bankruptcy Code. Accordingly, it is "incumbent" on this Court not to approve the Disclosure Statement. *Pecht*, 57 B.R. at 139.[8]

B. The Plan Does Not Contain Adequate Information Regarding Verizon's and Other ILECs' Contracts.

21. For the reasons stated above, the Plan is unconfirmable and this Court should not approve the Disclosure Statement for that reason alone. But, even if the Court were otherwise inclined, it should require, at a minimum, that the Debtors substantially amend the Disclosure Statement. The Debtors should not be permitted to hide, by burying in a definition (Tariff Services) in their Plan, that they intend not to treat any services provided by tariff as subject to

[8] It is worth noting that Sections 6.2 and 6.3 of this Plan, and the Debtors' proposed treatment of the claims of Verizon and other ILECs, fundamentally conflict with the resolution of these issues in virtually every other Chapter 11 telecommunications cases in which Verizon has been a party in interest. In case after case, including close to a dozen in this district alone, the debtors have assumed their contracts with Verizon and paid Verizon the required monetary cure. That happened in each of the following cases: *In re WorldCom, Inc.*, 02-13533 (Bankr. S.D.N.Y.); *In re Global Crossing Ltd.*, 02-40188 (Bankr. S.D.N.Y.); *In re CTC Communications Group, Inc., CTC Communications Corp.*, *CTC Communications of Virginia, Inc., and CTC Communications Leasing Group*, 02-12873 (Bankr. D. Del.); *In re Network Plus Corp.*, 02-10341 (Bankr. D. Del.); *In re Network Access Solutions Corp. & NASOP, Inc.*, 02-11611 and 02-11612 (Bankr. D. Del.); *In re Adelphia Business Solutions, Inc.*, 02-11389 (Bankr. S.D.N.Y.); *In re Arch Wireless, Inc.*, 01-47330 (Bankr. D. Mass.); *In re ATS Telecomms. Systems, Inc.*, 01-33453 (Bankr. S.D. Tex.); *In re Cable & Wireless USA, Inc.*, 03-13711 (Bankr. D. Del.); *In re EXDS, Inc. (f/k/a Exodus Communications, Inc.)*, 01-10539 (Bankr. D. Del.); *In re FastNet Corporation*, 03-23143 (Bankr. E.D. Pa.); *In re Focal Communications Corp.*, 02-13709 (Bankr. D. Del.); *In re Genuity Inc.*, 02-43558 (Bankr. S.D.N.Y.); *In re Logix Communications Corp. and Logix Communications Enters., Inc.*, 02-32105 and 02-32106 (Bankr. S.D. Tex); *In re Mpower Holding Corporation*, 02-11046 (Bankr. D. Del.); *In re Northpoint Communications Group, Inc.*, 01-30127 (Bankr. N.D. Cal.); *In re Plan B Communications, Inc.*, 01-11443 (Bankr. S.D.N.Y.); *In re Telscape Int'l., Inc.*, 01-1563 (Bankr. D. Del.); *In re PSINet Inc.*, 01-13213 (Bankr. S.D.N.Y.); *In re Rhythms NetConnections Inc.*, 01-14283 (Bankr. S.D.N.Y.); *In re RSL COM PrimeCall, Inc. and RSL COM U.S.A., Inc.*, 01-11457 and 01-11469 (Bankr. S.D.N.Y.); *In re Teligent, Inc.*, 01-12974 (Bankr. S.D.N.Y.); *In re TSR Wireless, LLC*, 00-41857 and 00-41858 (Bankr. D.N.J.); *In re Usinternetworking, Inc.*, 02-50215 (Bankr. D. Md.); and *In re World Access, Inc.*, 01-1286 (Bankr. D. Del.).

the requirements of Section 365. Rather, the Debtors should be required to prominently disclose this fact in plain English in the Disclosure Statement. Moreover, the Debtors should be required to disclose that Verizon (and, as applicable, other ILECs or additional telecommunications providers that file similar objections to the Disclosure Statement) contend that Sections 6.2 and 6.3 of the Plan are unlawful and will need to be changed materially, or deleted altogether, for the Plan to be confirmed.

22. Such meaningful disclosure is absolutely necessary. Section 1125 requires that the Disclosure Statement provide "adequate information" that "would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan." 11 U.S.C. § 1125(a)(1). The purpose of this requirement is, of course, to allow creditors to vote and participate in the plan process based on informed judgment. *See Kunica v. St. Jean Fin., Inc.*, 233 B.R. 46, 54 (S.D.N.Y. 1999). As the courts have repeatedly held, full disclosure "is crucial to the effective functioning of the federal bankruptcy system[;] . . . the importance of full and honest disclosure cannot be overstated." *Ryan Operations G.P. v. Santiam-Midwest Lumber Co.*, 81 F.3d 355, 362 (3d Cir. 1996). *See also Oneida Motor Freight, Inc. v. United Jersey Bank*, 848 F.2d 414, 417 (3d Cir.), *cert. denied*, 488 U.S. 967 (1988) ("we cannot overemphasize the Debtor's obligation to provide sufficient data to satisfy the code standard of 'adequate information'"); *In re Crowthers McCall Pattern, Inc.*, 120 B.R. 279, 300 (Bankr. S.D.N.Y. 1990) ("Given the necessity for adequate information in the Disclosure Statement and the paramount importance Section 1125 occupies in the Chapter 11 process, there is little, if any, room for harmless error"). Real disclosure of the substantial issues raised by this Objection is necessary because the Disclosure Statement must "contain all material information relating to the risks posed to creditors and equity holders under the

proposed plan of reorganization." *In re Cardinal Congregate I*, 121 B.R. 760 (Bankr. S.D. Ohio 1990).

II. The Plan's Treatment of the Structurally Subordinated Claims of the Note Holders Violates the Absolute Priority Rule and Is Accompanied by Inadequate Disclosure in the Disclosure Statement.

23. Not only does the Plan purport to deny Verizon and other ILECs their rights to payment in full of all amounts owed as a cure under Section 365, but, after relegating those telecommunications providers to the status of general unsecured creditors, denies them their most fundamental right as such a creditor: the right to be paid in full before equity holders receive anything. Verizon and other trade creditors have claims against the Debtors' operating subsidiaries. In contrast, the holders of the Debtors' unsecured notes have claims only against one of the Debtors, Allegiance Telecom, Inc., the ultimate parent. The Debtors thus admit that the notes were issued by (and only by) ATI pursuant to indentures to which ATI (not the other Debtors) were parties and that none of the other Debtors guaranteed or granted security for payment of the notes:

> In 1998, ATI issued two series of notes: (i) 11 ¾% Senior Discount Notes with a face value of $445 million . . . (the "Senior Discount Notes") and (ii) 12 7/8% Senior Notes with a face value of $205 million . . . (the "Senior Notes," and together with the Senior Discount Notes, the "ATI Notes"). The Senior Discount Notes were issued under that certain Indenture, dated as of February 3, 1998, between ATI and the Bank of New York . . . . The Senior Notes were issued under that certain Indenture, dated as of July 7, 1998 between ATI and the Bank of New York . . . . Neither the Senior Discount Notes nor the Senior Notes are secured by any assets of the Debtors or guaranteed by any of the Debtors.

Disclosure Statement, at 8.

24. ATI is a holding company, apparently, on information and belief, without any assets other than the stock it holds in its operating subsidiaries. Thus, ATI can make distributions to the note holders only if it receives dividends from its operating subsidiaries, which, under the absolute priority rule, could pay such dividends only after all allowed claims (whether secured or unsecured) against those debtors had been paid in full with postpetition interest. *See, e.g.,* 11 U.S.C. § 1129(b)(2)(B). Again, the Debtors admit as much: "the holders of ATI Note Claims, based on the absolute [priority] rule, would be entitled to distributions only after all claims against ATCW and the Subsidiaries were paid in full." Disclosure Statement at 19.

25. But the Plan provides nothing of the kind. On the contrary, while it separately classifies holders of ATI Note Claims (perhaps to obtain an accepting impaired class), it provides for them to receive either the exact same treatment, or the economic equivalent, as holders of trade claims will receive against the operating subsidiary Debtors.[9] The Plan thus violates the absolute priority rule because it permits structurally subordinated noteholders to receive distributions – indeed the same or equivalent distributions – as structurally senior trade creditors.

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[9] The only difference in the treatment accorded holders of ATCW Unsecured Claims and holders of ATI Unsecured Claims appears to be that, while both are given the right to elect to receive cash or securities in satisfaction of their claims, "in the event that the Available Cash is insufficient to satisfy in full the Claims of All Holders in Class 4 [the trade class] that elect a Cash Recovery … the Holders of Allowed Claims in Class 5 [the noteholders] will not be entitled to any Cash Recovery" and, instead, their claims shall "be satisfied" through the distribution of various securities. Disclosure Statement at 23; Plan § 3.5(a). There is no indication in the Disclosure Statement of how likely this occurrence is; it is therefore reasonable to assume that holders of Class 4 Claims and Holders of Class 5 Claims will receive exactly the same form of distributions. In any event, it appears (there certainly is nothing in the Disclosure Statement suggesting to the contrary) that the securities to be distributed are intended to provide the noteholders approximately the same pro rata distribution as the cash distributions will provide trade creditors who elect to take their distributions in cash.

26. The Disclosure Statement contains only two paragraphs that shed any light at all on the supposed "justification" for this violation of the absolute priority rule. Those paragraphs provide:

> The Plan incorporates a proposed compromise and settlement of all issues related to [the] validity and priority of ATI Note Claims raised in the proofs of Claim filed by the ATI Note Trustees against each of the Debtors on January 12, 2004 with the Bankruptcy Court. Specifically, based on its review of the Credit Agreement, the ATI Note Indentures and applicable law, the ATI Note Trustees allege in the applicable proofs of Claim that (a) the Debtors may have granted certain liens and guarantees to the Senior Lenders under the Credit Agreement in violation of the affirmative negative pledge covenants contained in the ATI Note Indentures and, as a result, (b) the Holders of ATI Note Claims may be entitled to claims against all of the Debtors based on the guaranties and equal and ratable liens against all the assets of the Debtors. Consequently, the ATI Note Trustees assert that the ATI Note Claims are secured claims. The Debtors and the Senior Lenders dispute the ATI Note Trustees' allegations.
>
> If the Bankruptcy Court determined that the ATI Note Trustees' allegations were legally valid and, accordingly, that the ATI Note Claims constituted Allowed Secured Claims in the full amount of approximately $676,050,190.97, as asserted in the proofs of claim filed by the ATI Note Trustees, then the ATI Note Claims would be treated pari passu with the Senior Lender Claims. In such event, the Holder of ATI Note Claims would receive significant distributions on account of such ATI Note Claims and the Holders of Allowed Unsecured Claims, based on the absolute priority rule, would receive no distribution. However, if the Bankruptcy Court determined that the allegations of the ATI Note Trustees are not legally cognizable and, accordingly, the ATI Note Claims constituted Allowed Unsecured Claims, then the ATI Note Claims would be structurally subordinated to . . . the ATCW Unsecured Claims. In such event, the Holders of ATI Note Claims, based on the absolute [priority] rule, would be entitled to distributions only after all claims against ATCW and the Subsidiaries were paid in full.

Disclosure Statement at 19.

27. That brief description of this paramount issue is woefully inadequate as a matter of disclosure and does not come close to justifying the Debtors' violation of the absolute priority

rule as a matter of substance. As to the former, there is no discussion at all of the supposed "affirmative negative" covenants (whatever that means) that the ATI Note Trustees claim the Debtors violated. There is also no explanation of the legal theory that the ATI Note Trustees advanced – as discussed below, none appears plausible – as to how any such violation of a covenant could somehow convert the unsecured noteholder claims against ATI into secured (or even unsecured) claims against all the Debtors. There is likewise no discussion as to the grounds on which the Debtors – fiduciaries for all creditors – "dispute" the ATI Note Trustees' claim. And there is absolutely no disclosure of the effect of this supposed "settlement" on the recovery of trade creditors. If, as Verizon suspects may be the case, the trade creditors would be entitled to payment in full, or close to it, if the $677 million in noteholder claims were properly treated as structurally subordinated rather than as *pari passu* with the trade claims, they have a right to know that.

28. As a substantive matter, without material disclosure providing some basis for it, the ATI Note Trustees' claim appears to be frivolous. It is hard to imagine that the Debtors would have granted liens on substantially all their assets, and each of the Debtors would have become obligated on the $477.8 million in debt allegedly owed to the Senior Lenders, if doing so truly violated one or more covenants in the ATI Note Indentures. And it is equally hard to imagine that, if that secured borrowing did truly violate such a covenant in the ATI Note Indentures, the ATI Note Trustees would have waited nearly six months – the secured Credit Agreement is dated November 27, 2002, and the Debtors did not file for bankruptcy until May 14, 2003 – to so assert.

29. In any event, even if ATI did violate a covenant in the indentures for the notes, that simply would mean that there would be another breach (in addition to the nonpayment of the

notes) by ATI thereunder and that the noteholders would now have two bases – non-payment and breach of covenant – to assert their unsecured claims against ATI. Such a violation might, perhaps, even give rise to a claim by the noteholders directly against the Senior Lenders for aiding and abetting ATI's violation. But there is no conceivable basis under law to assert that any violation by ATI, with or without the substantial assistance and knowledge of the Senior Lenders, could be held to warrant disadvantaging parties who unquestionably did not violate (or aid and abet ATI's alleged violations of) the covenants: the trade creditors. Put differently, if the Senior Lenders had not been granted the security interest in certain collateral and guarantees of payment by all the Debtors that the ATI Note Trustees allege violate the ATI Note Indentures, the noteholders would have still been structurally subordinate to the trade creditors. While the noteholders might be able to assert a claim to be put in the same position they would have been without the alleged covenant violation – structurally subordinate unsecured creditors – that alleged breach most surely would not allow them to improve their position and obtain a windfall. Yet, that is exactly what they are seeking – to become secured creditors against all the Debtors, ahead of the wholly innocent trade creditors, something they unquestionably were not before the alleged covenant violation by the Debtors and the Senior Lenders.[10]

[10] The only other conceivable "justification" for the dilution of the claims of the trade creditors under the Plan alluded to in the Disclosure Statement is the suggestion that some of the proceeds of the notes were down-streamed by ATI to its operating subsidiaries and that such down-streaming might – or might not – be treated as debt, giving rise to intercompany claims by ATI against the subsidiaries that might – or, again, might not – be entitled to *pari passu* treatment with the claims of the trade creditors against the operating subsidiaries. But this provides no justification at all for the Plan's treatment of the trade claims and noteholder claims as *pari passu*, and the Disclosure Statement's description of the Plan as providing a "compromise and settlement" of these issues (Disclosure Statement at 19) is utterly misleading. The Debtors acknowledge that funds down-streamed by ATI to the subsidiaries could also be characterized as equity contributions, not debt (or, at most, as subordinated debt in light of ATI's status as an insider). The Plan does not provide any sort of compromise on this issue. It affords

30. In short, there is no conceivable basis for the supposed "settlement" that lies at the very heart of this Plan and the adverse treatment of Verizon and other trade creditors.[11] In this respect as well, the Plan is not confirmable on its face and, for that reason, approval of the Disclosure Statement should be denied. Moreover, even if the Court is otherwise inclined to permit the Debtors to begin soliciting acceptances of the Plan, the Disclosure Statement needs to be substantially amended to provide real, meaningful disclosure on this critical issue, so that holders of ATCW Unsecured Claims can make an informed judgment as to whether or not to support the Plan. If the Debtors wish to so drastically reduce the recoveries of all their trade creditors, the Disclosure Statement must provide a great deal more information, including a discussion of the covenants in the ATI Note Indentures that allegedly have been violated and an intelligible discussion of how, even if the ATI Note Indentures were in fact breached, the ATI Note Trustees could plausibly be entitled to the relief they seek. Without such "adequate information," this Court should not approve the Disclosure Statement.

31. Finally, because there are no novel issues of law presented herein, Verizon respectfully requests that this Court waive the requirement of Local Bankruptcy Rule 9013-1(b) that Verizon file a separate memorandum of law in support of this Objection.

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the noteholders a complete "win," giving them the most relief they could ever expect on this issue if they were totally successful in litigation: *pari passu* treatment with the trade creditors.

[11] The Debtors' self-serving characterization of the Plan's treatment of the noteholders' claims as a "compromise" cannot turn a sow's ear into a purse. "[T]he court may not simply rubber stamp the recommendation of a trustee or debtor in possession but, instead, must make an independent, 'full and fair assessment of the wisdom of the proposed compromise.'" *In re Remsen Partners, Ltd.*, 294 B.R. 557, 565 (Bankr. S.D.N.Y. 2003) (internal quotation marks and citation omitted).

CONCLUSION

WHEREFORE, Verizon requests that this Court (i) decline to approve the proposed Disclosure Statement and to permit the Debtors to begin soliciting acceptances of the Plan, unless and until and the Disclosure Statement and the Plan are amended so that the Disclosure Statement provides "adequate information" within the meaning of Section 1125, and so that it is conceivable that the Plan could be confirmed under Section 1129, of the Bankruptcy Code, and (ii) grant Verizon such other and further relief as this Court deems appropriate.

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Respectfully Submitted,

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