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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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

OBJECTION OF KMC TELECOM XI LLC TO DEBTORS' DISCLOSURE STATEMENT PURSUANT TO SECTION 1125 OF THE BANKRUPTCY CODE

KMC Telecom XI LLC ("KMC"), hereby objects to the Debtors' Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code dated March 18, 2004 (the "Disclosure Statement" or "D.S."), on the grounds that (a) the Disclosure Statement lacks adequate information as required under section 1125(a) of title 11 of the United States Code (the "Bankruptcy Code") and (b) the Disclosure Statement describes a plan that is not confirmable as a matter of law pursuant to Section 1129 of the Bankruptcy Code (the "Objection").

As this Court may recall, KMC was party to certain agreements with Allegiance Telecom Company Worldwide ("ATCW"), one of the Debtors. One of these agreements, the

Primary Rate Interface Services Agreement dated February 11, 2002 (the "KMC Agreement"), was assumed and assigned to Level 3 by order entered on March 31, 2004, which subsequently was amended by order entered on April 6, 2004 (the "Level 3 Order"). However, the disposition of a second agreement, the Colocation Agreement, remains open, pending this Court's determination or other resolution as to whether the KMC Agreement and Colocation Agreement should be deemed part of a single agreement or be regarded as severable. Level 3 Order, at 6. Accordingly, at this point, KMC is obliged to protect its position as a unsecured creditor of the ATCW estate, because it will have millions of dollars in claims against ATCW in the event the Colocation Agreement is deemed severable and rejected.

For the reasons set forth below, the Plan and Disclosure Statement filed by the Debtors evidence an intention to subvert the interests of KMC and other ATCW creditors, without providing adequate information that would advise those creditors of the extent to which their rights are being diminished in the guise of a purported "compromise."

In support of its Objection, KMC respectfully represents as follows:

PRELIMINARY STATEMENT

1. When the Plan emerged from the deliberations between the Debtors, the Secured Lenders, and the Committee (the majority of whose members are bondholders), it provided for the Secured Lenders to be paid in full, and for all the residual assets of the estates to be shared *pari passu* among unsecured creditors – even though the estates' assets are at the operating debtor level, and the majority of their liabilities are bondholder claims at the holding company level. Despite the substantial modification of creditor rights which results from that treatment, the Disclosure Statement contains an astoundingly thin description of the issues which led to this result, omits even a statement of the percentage recovery which creditors can anticipate, and relies on a liquidation analysis that ignores the XO and Level 3 transactions

which have already been approved by this Court. The purpose of a Disclosure Statement is to inform and advise; in KMC's view, the effect, if not the purpose, of the Debtors' Disclosure Statement is to conceal. Accordingly, KMC urges that the Disclosure Statement not be approved.

BACKGROUND

2. The key feature of the proposed Plan is the extent to which it purports to equalize distributions to the unsecured creditors of each of the debtors' estates. For purpose of this objection, two entities are of principal significance – Allegiance Telecom, Inc. ("ATI"), the holding company which is the lead named debtor in these cases, and ATCW, its first tier operating subsidiary, which also directly or indirectly owns the capital stock[1] of all 37 other Debtors.[2]

3. The equalization of distributions is being effected despite the distinct disparity in this case between which debtor owns the assets, and which debtor owes most of the debt. With respect to the liabilities, as is so often the case, the public debt issued by the debtors, aggregating some $650 million (the "ATI Notes") resides at the holding company level.[3] All of this bond debt is unsecured, and it was not guaranteed by any of the other Debtor entities. See D.S., at III.B.4. (p.8). On the other hand, the unsecured trade debt of these Debtors was largely

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[1] See Affidavit of G. Clay Myers Pursuant to Local Bankruptcy Rule 1007-2, Docket No. 3, at § 19.

[2] The Plan (§§ 1.7, 1.8, 1.9, 3.4(a)) also proposes to substantively consolidate each of the debtor subsidiaries of ATCW into ATCW. The objections set forth herein as to what is in effect a substantive consolidation of ATI and ATCW applies to the substantive consolidation of these subsidiaries as well. Among other things, the Disclosure Statement (at § V.I. (pp. 32-33)) fails to set forth the basis for that substantive consolidation, the arguments why such substantive consolidation would not be appropriate, and the impact on the creditors of each entity if substantive consolidation did not occur. Given the lack of this information, KMC cannot even evaluate the extent to which, if at all, it is being adversely affected by this substantive consolidation of ATCW and its subsidiaries.

[3] This comprises two series of notes issued by ATI in 1998: (i) $445 million in 11 3/4% Senior Discount Notes due February 15, 2008, (the "Senior Discount Notes"); and (ii) $205 million in 12 7/8% Senior Notes due May 15, 2008 (the "Senior Notes" and, together with the Senior Discount Notes, the "ATI Notes"). See Disclosure Statement, at § III.B.4. (p. 8).

incurred by ATCW or its subsidiaries.[4] The distribution of the estates' assets, however, is quite different. Although the Disclosure Statement does not discuss the issue, KMC also believes that substantially all of the assets in this case – including the vast bulk, if not all, of the $273.5 million of cash on hand (D.S., Ex. I, at 3), the $311.2 million of cash and $241.9 million in stock to be received in the sale to XO (see D.S. at § IV.G.3. (p. 17), § IX.D. (p. 46)), and the $54 million in proceeds of the settlement with Level 3, as well as to assets or stock interests which will comprise Reorganized STFI, valued at another $40 million (see D.S. at § VIII.B. (pp. 41-42)) – reflect assets held at the ATCW level, and do not represent assets directly owned by ATI.

4. Perhaps as a token nod to this disparity, the Debtors' proposed Plan (the "Plan")[5] purports to separate unsecured creditors into two classes: (i) ATCW Unsecured Claims (Class 4), which is comprised of unsecured claims against ATCW and all of the other Debtors aside from ATI; and (ii) ATI Unsecured Claims (Class 5), which consists of unsecured claims against ATI. See Plan, at §§ 1.7, 1.8, 1.9, 1.10, 1.15, 3.4 and 3.5. This separate structure, however, has no economic substance. Under the Plan, all unsecured claims, regardless of whether they lie most properly against ATI, ATCW or any of the other Debtors, are to share *pro rata* in one pool of assets for distribution purposes – even though the Debtors' assets were not at the ATI level.[6]

5. Thus, the only significance of the separate classification of ATI and ATCW claims is that it allows each class of creditors to vote for or against the Plan – which

[4] The Disclosure Statement does not contain an estimate or other analysis of the trade debt at the ATCW level (although Exhibit I contains a $420.3 million figure), and also does not explain the origin of non-bond debt at ATI. Compare Disclosure Statement at 5 (estimated ATI unsecured debt of $677.2 million) with Plan, § 1.11 (allowance of ATI Note Claims at $642.8 million). This lack of information as to claims is one of the failings identified below.

[5] All capitalized terms used herein that are not otherwise defined herein shall have the meanings ascribed to them in the Plan or the Disclosure Statement, as applicable.

[6] The way the Plan seeks to accomplish that result is by defining the *pro rata* distribution of each class of unsecured claims, whether they be against ATI or ATCW, in terms of the ratio between their individual claim and "the sum of

makes it even more critical that each class is advised as to all the issues that affect its rights. But the Disclosure Statement does not do so, but instead omits any real discussion of what ATCW Creditors would receive but for the Plan's *de facto* substantive consolidation, and provides only a cursory and incomplete analysis of the legal issues, all in an attempt to bless the current arrangement as a "compromise" approved by the principal case constituencies. For these reasons, the Disclosure Statement fails in its essential purpose of advising creditors of their rights, and KMC objects.

ARGUMENT

I. THE DISCLOSURE STATEMENT FAILS TO PROVIDE "ADEQUATE INFORMATION" AS REQUIRED BY THE BANKRUPTCY CODE

6. Pursuant to Section 1125(b) of the Bankruptcy Code, the Debtors may not solicit votes on the Plan until this Court finds that the Disclosure Statement contains "adequate information," which is defined by Bankruptcy Code Section 1125(a)(1) as:

> [I]nformation of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, 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). See also, Abel v. Shugrue (In re Ionosphere Clubs, Inc.), 179 B.R. 24, 25 n.1, 29 (S.D.N.Y. 1995) (noting that what constitutes "adequate information" is subjective and the determination is made on a case-by-case basis); In re Crowthers McCall Pattern, Inc., 120 B.R. 279, 300 (Bankr. S.D.N.Y. 1990) (finding that at the "heart" of the chapter 11 process is the requirement that holders of claims in impaired classes be furnished with a proper disclosure statement); see also, In re I. Appel Corp., 300 B.R. 564, 569 (S.D.N.Y. 2003); In re

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(continued…)
all (1) Allowed ATCW Unsecured Claims and (2) Allowed ATI Unsecured Claims." See Plan, at §§ 3.4(a), 3.5(a).

Clamp-All Corp., 233 B.R. 198, 204 (Bankr. D. Mass. 1999); In re Ferretti, 128 B.R. 16, 18-19 (Bankr. D.N.H. 1991).

7. As set forth below, the Disclosure Statement fails to provide adequate information in three areas: (i) there is no disclosure that the Debtors are, in essence, being substantively consolidated, despite the inappropriateness of substantive consolidation under applicable Second Circuit law, and insufficient disclosure as to the pros and cons of the issues which are being advanced to justify the purported "compromise" that effects the *de facto* substantive consolidation that diminishes the rights of ATCW unsecured creditors; (ii) the Disclosure Statement fails to set forth information as to the anticipated range of recoveries to be afforded unsecured creditors in Classes 4 and 5 under the Plan, both under their proposed Plan treatment and what might be achieved if the "compromise" were not imposed; and (iii) the Disclosure Statement (Exhibit I) includes a liquidation analysis which, misleadingly, is premised on the dismemberment and liquidation of the Debtors' individual assets, rather than the consummation of the asset disposition transactions – the sale to XO and the Level 3 settlement – which already have been approved by this Court. For these reasons, approval of the Disclosure Statement must be denied.

A. The Disclosure Statement Contains Misleading and Inadequate Information as to the Effect of and Basis for the Plan's *de facto* Substantive Consolidation

8. The Plan effects two substantive consolidations. One is explicit – the substantive consolidation of ATCW and its subsidiaries into the "ATCW Debtors." Although there is a striking and objectionable paucity of detail as to the basis for and impact of that consolidation (which is itself objectionable for the reasons discussed in footnote 2 supra), the Disclosure Statement is at least upfront that this "deemed consolidation" is taking place. See D.S. at § V.I. (pp. 32-33). With respect to ATI and ATCW, by contrast, the Disclosure Statement does not even refer to substantive or deemed consolidation, even though the Plan's

asset sharing provision will have exactly the same effect on creditor distributions. To provide adequate information, the Disclosure Statement should have disclosed explicitly that a substantive consolidation of ATI and ATCW is being effected, and set forth in detail the fact that ATI and ATCW did not otherwise meet the standards for substantive consolidation (see discussion at ¶¶ 13-19, infra). It should also explain why, given that substantive consolidation standards are not met, the Debtors elected to accomplish their *de facto* substantive consolidation by other means.

9. The flaw in the Disclosure Statement is far deeper, because the explanation for the "compromise" that the Disclosure Statement does provide is woefully deficient. The Disclosure Statement is 57 pages long and contains hundreds of pages of exhibits, but devotes only two pages (see pp. 18-20) to advise creditors of the purported "compromise and settlement" which led to the *de facto* substantive consolidation of ATI and ATCW. Talking about two pages overstates the degree of disclosure; one of those pages is largely devoted to advocacy of the Plan's outcome as the outcome of "lengthy and arm's-length settlement negotiations"[7] among the Debtors, the Senior Lenders, and the Creditors' Committee, which is portrayed as a "fair and equitable settlement" which would benefit the estate. Thus, the Disclosure Statement has only a single page devoted to the basis for "compromise" itself, and this consists of a very cursory discussion of the three identified issues that are the subject of the "compromise" – the alleged violation of a negative pledge clause, the possible equitable subordination of the Senior Lenders' claims, and the accounting for intercompany transfers between ATI and ATCW. See D.S. at § V.A.4. (pp. 18-20).

[7] There should be at least some question over the "arms' length" nature of these settlement discussions, given that the majority of the Creditors' Committee is composed of bondholders. See Disclosure Statement, at § IV.A. (pp. 9-10).

10. This bare-bones discussion does not meet the standards of Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414 (1986) (hereinafter, "TMT Trailer"), which the Debtors correctly cite as the governing standard for settlements. TMT Trailer requires more than a conclusory assertion that, in light of the probability of success in any litigation over three identified issues, and the complexity, expense and likely duration of litigation, the Compromise and Settlement is "within the range of likely results." D.S., at § V.A.4. (p. 20). Rather, in TMT Trailer, the Supreme Court held that compromises reached during the course of insolvency proceedings must be "fair and equitable." 390 U.S. at 424. The Court stated that "basic to this process in every instance, of course, is the need to compare the terms of the compromise with the likely rewards of litigation." Id. at 424-25. This requirement is not satisfied here, because the Disclosure Statement does not even contain a comparison of the possible recoveries for ATCW creditors if they prevail on the disputed issues, compared to what they are proposed to be paid under the Plan.

11. Beyond that, and perhaps even more important, the Rule 9019 standards enunciated in this Circuit also demand that the terms of the settlement, in light of the strengths and weaknesses of each side, do not fall "below the lowest point in the range of reasonableness." Cosoff v. Rodman (In re W.T. Grant Co.), 699 F.2d 599, 613 (2d Cir. 1983) (internal quotation omitted). Yet the single page in the Disclosure Statement as to the issues that are purported to be compromised do not contain enough detail to permit creditors to assess whether the proposed settlement is a fair one. Given that the Plan contemplates soliciting the votes of ATCW Creditors as a class, that class must be advised on how much they are being asked to sacrifice, and for what. The Disclosure Statement does not do so, as a brief review of the three identified issues that are being compromised will readily demonstrate:

(a) Violation of Negative Pledge. According to the Disclosure Statement, the ATI Note Trustee alleges that the Senior Lenders obtained certain unidentified collateral and guaranties in violation of a negative pledge clause in the ATI Notes, and asserts, without citation of authority, that the remedy for this violation is the grant the same guaranties and liens to the ATI Note Trustee. But the Disclosure Statement provides no support for this leap of logic. One would have supposed that if the Senior Lenders' liens and guaranties were in violation of the rights of ATI Note holders, the remedy would be to set aside those liens and guaranties, to undo the impact of any violation. But because that would serve only reduce the distribution payable to the Senior Lenders, and increase the corresponding distribution to ATCW Creditors. It would provide no benefit to the ATI Noteholders, whose claims would still be structurally subordinated at the holding company level. Accordingly, the ATI Note Trustee contends that the remedy for an illegal pledge is to grant the same pledge to someone else!

No cases are cited in support of this illogical proposition. Indeed, one of the pillars of bankruptcy law is the right of a trustee to set aside liens that were improperly granted, wrongly perfected, or violative of others' rights, such as fraudulent conveyances. It hardly makes sense, therefore, that the remedy for the Secured Lender's violation here would be to grant yet another lien to the ATI Note holders – which had neither a prepetition grant of lien, nor effected a prepetition lien perfection – especially where doing so would further disadvantage unsecured creditors. See, e.g., XL/Datacomp, Inc. v. Wilson (In re Omegas Group, Inc.), 16 F.3d 1443, 1452-53 (6th Cir. 1994) (imposition of constructive trust is contrary to bankruptcy principles and would not be approved); In re Paul J. Paradise & Assocs., Inc., 249 B.R. 360, 371-72 (D. Del. 2000) (follows majority rule that trustee's strong arm powers under § 544(a) overcome constructive trust rules).

The Disclosure Statement, however, discusses none of these issues. It merely

states the position of the ATI Note Trustee, without any critical analysis, and without any demonstration that the sacrifice to be made by the ATCW Creditors is commensurate to the risks they would face from the ATI Note Trustee's novel theory. This plainly is not sufficient.

(b) Equitable Subordination of Senior Lender Claims. The Disclosure Statement also states that the "compromise" seeks to resolve the contention by the Creditors' Committee that the Senior Lenders' claim should be equitably subordinated under § 510(c) of the Bankruptcy Code, and that $26 million of the Debtors' cash was not subject to their lien. See D.S., at § V.A.2. (p. 19). None of this seems to have anything to do with the decision to conflate the ATI and ATCW estates to the prejudice of ATCW Creditors. In addition, the Plan hardly evidences any "compromise" of this claim, because Senior Lenders under the Plan are being paid in full! Thus, like the "compromise" of the wrongful lien claim discussed in the previous paragraph, the "compromise" of the equitable subordination claim against the Senior Lenders is a Plan which pays the Senior Lenders in full, but reduces the recoveries otherwise attainable by ATCW unsecured creditors. Why ATCW Creditors are asked to bear the brunt of the flaws in other constituencies' position is nowhere explained – nor is there sufficient information to enable the typical reader to appreciate that the "compromise" on this issue does not pass muster. Again, such "disclosure" does not meet the standards of § 1125.

(c) Characterization of Intercompany Transfers or Balances. The third issue identified in the Disclosure Statement is the characterization of intercompany cash transfers, and in particular whether they should be treated as debt or equity. According to the Debtors, treatment of transfers of ATI to ATCW as debt would swamp the unsecured creditors at ATCW, and result in a lesser recovery for them (allegedly "insignificant value") than under the Debtors' plan.

Apart from these conclusory statements, the Disclosure Statement does not

contain sufficient material to enable ATCW Creditors to evaluate the alleged threat to their position posed by this purported intercompany claim. For example, the Disclosure Statement does not provide separate company balance sheets that show the amount of the intercompany claim, if any, that was in fact historically maintained on the Debtors' books. It does not discuss whether intercompany transfers were booked as loans, whether notes were issued, and whether interest on those balances was accrued, all of which are indicia of whether debt was *bona fide*. It does not consider whether – assuming intercompany balances were maintained as intercompany liabilities – the case could still be made that these intercompany loans could or should be equitably subordinated, because, for example, ATCW as undercapitalized, or because no such loans would have been made by unrelated parties under the circumstances, or because ATI exercised such domination and control over ATCW as to make it inequitable that it be treated as a creditor rather than a shareholder of the ATCW estate.[8] Indeed, it seems bizarre that the ATI Note Trustee, representing the bondholders, would assert that the conduct of the Senior Lenders was such as to require equitable subordination of their claims, while the same constituencies would contend that ATI's intercompany claims, if indeed they were ever characterized as debt,

[8] See, e.g., In re AutoStyle Plastics, Inc., 269 F.3d 726, 749-50 (6th Cir. 2001) (seminal case on recharacterization; setting forth eleven criteria for use in determining whether debt may be recharacterized as equity, including: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments). Recharacterization is similar to equitable subordination in its effects, but while recharacterization turns on whether a debt actually exists, equitable subordination turns on whether a legitimate creditor engaged in inequitable conduct, in which case the remedy is subordination of the creditor's claim "to that of another creditor only to the extent necessary to offset injury or damage suffered by the creditor in whose favor the equitable doctrine may be effective." See In re Sub Micron Systems Corp., 291 B.R.314, 322-23 (D. Del. 2003) (quoting In re AutoStyle Plastics, Inc., 269 F.3d at 749); see also, In re W.T. Grant Co., 4 B.R. 53, 74 (Bankr. S.D.N.Y. 1980) (equitable subordination is to be used sparingly and where claimant sought to be subordinated (a) has acted in a fiduciary capacity; (b) has breached a fiduciary duty; (c) that breach resulted in detriment to those claimants to whom a duty was owed; or (d) committed an act of moral turpitude, causing damages to other creditors).

should be immune from such equitable subordination!

None of this is discussed or explained in the Disclosure Statement. Instead, the Debtors state only that based on the investigation of the Creditors' Committee, "it is unclear" whether the intercompany amounts are loans or capital contributions. Because the reasons for this lack of clarity are not set forth, creditors are not in a position to evaluate the appropriateness of the proposed "compromise," but are asked simply take it on faith that it is fair. That is not sufficient disclosure.

12. Apart from its failure to adequately discuss the substance of its proposed "compromise," the Disclosure Statement also fails to explain the process by which that "compromise" was reached. It is no secret, for example, that a majority of the Creditors' Committee consists of bondholder representatives.[9] Were negotiations conducted within the Creditors' Committee to arrive at the Plan's "compromise"? Were trade and bondholder members represented during those negotiations by separate counsel and have the benefit of separate financial advisors? Did the individual Committee members who voted on this purported "compromise" have full information, or were they provided a truncated version of the facts, akin to what is set forth in the Disclosure Statement? Was the Committee vote unanimous? Given that the Disclosure Statement invites creditors to accept on faith that the "compromises" reached by the various constituency representatives was fair, it was incumbent that it provide an open window into the process of those negotiations, and not limit its discussion (as it does now) to the summary comment that a compromise was reached.

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[9] The Committee's counsel and financial advisors have longstanding ties with bondholder groups, and often represent bondholder and bondholder-dominated committees. Although KMC is not suggesting that these professionals did not properly fulfill their fiduciary duties to all creditors, the professionals' prior bondholder involvements (and the process by which they came to obtain the instant engagement) are additional facts that should be disclosed because they may be of interest to unsecured creditors who are being disenfranchised by the "compromise" which these professionals negotiated or endorsed.

13. Finally, the Disclosure Statement is deficient in not including a full discussion of the issues of substantive consolidation, which are being implemented directly – in the case of the ATCW Debtors – or indirectly, in the *de facto* substantive consolidation of ATI and ATCW. To give creditors the requisite context and background for what the Plan seeks to accomplish, directly or indirectly, the Disclosure Statement should have discussed the legal and equitable principles embodied in the doctrine of substantive consolidation,[10] as well as the extent to which they might (or might not) apply to the facts of these cases. The Disclosure Statement, however, contains virtually no discussion of these issues.

14. This omission is particularly glaring, because the standards for substantive consolidation are far more rigorous in the Second Circuit than in some other jurisdictions – and these exacting standards make it highly likely that the standards for substantive consolidation are not met here.[11] In the Second Circuit, courts seeking to substantively consolidate are obliged to review the historical affairs of the debtor against a list of criteria that, fundamentally, can be distilled down to "two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors." In re

[10] Substantive consolidation is a judicially created doctrine flowing from the general equity powers granted to federal bankruptcy courts under section 105 of the Bankruptcy Code. See, e.g., Fed. Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 59 (2d Cir. 1992); In re Leslie Fay Cos., 207 B.R. 764, 779 (Bankr. S.D.N.Y. 1997) ("Substantive consolidation derives from the bankruptcy court's equitable powers provided in section 105(a) of the Bankruptcy Code."). Effecting substantive consolidation essentially "pools" the assets and liabilities of multiple debtors and, in some cases, non-debtors. To the extent substantive consolidation is effected, intercompany claims and guarantees by other debtors are disregarded. See In re Augie/Restivo Baking Co. Ltd., 860 F.2d 515, 518 (2d Cir. 1988).

[11] Compare, e.g., In re Augie/Restivo Baking Co. Ltd., 860 F.2d at 518 (2d Cir. 1988) (collecting cases; substantive consolidation based on specific facts suggesting operation of multiple debtors as a single entity) with Eastgroup Props. v. Southern Motel Assoc., Ltd., 935 F.2d 245, 249 (11th Cir. 1991) (referring to consolidation to avoid some harm or to realize some benefit); Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.), 810 F.2d 270 (D.C. Cir. 1987)). See also R 2 Invs. LDC v. World Access, Inc., 301 B.R. 217, 273-74 (Bankr. N.D. Ill. 2003) (discussing the Augie/Restivo and Auto-Train/Eastgroup lines of authority).

Augie/Restivo Baking Co. Ltd., 860 F.2d at 518 (internal quotation and citation omitted).[12] Additionally, the substantive consolidation criteria can also be viewed as an inquiry into whether there exists a "cloak of fraud" or other inequitable, unjust, or unconscionable conduct or result that calls for equitable redress.

15. In this Circuit, substantive consolidation is the exception, not the norm. Indeed, as the Second Circuit has made clear, "substantive consolidation is no mere instrument of procedural convenience[,] but a measure vitally affecting substantive rights [which is] to be used sparingly." Augie/Restivo, 860 F.2d at 518 (internal quotation and citation omitted). Moreover, Augie/Restivo instructs that absent credible evidence to the contrary, parties' legitimate business expectations as to the creditworthiness of the particular entity with which they are dealing should be fulfilled:

> [C]reditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of their particular borrower for satisfaction of that loan. Such lenders structure their loans according to their expectations regarding that borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors of a less sound debtor compete with the borrower's assets.

Augie/Restivo, 860 F.2d at 518-19 (finding that the course of dealing and expectations in that case did not justify consolidation).

16. Not only does the Disclosure Statement lacks any discussion whatsoever on the standards for substantive consolidation, but it also fails to include any reasons why the

[12] Substantially the same standards are applicable under Delaware law with respect to the piercing of the corporate veil, which is the equivalent of substantive consolidation. See, e.g., In re JTS Corp., 305 B.R. 529, 557 (Bankr. N.D. Cal. 2003) (citing In re Foxmeyer Corp., 290 B.R. 229, 235 (Bankr. D. Del. 2003) (requirements that the corporation and its shareholders "must be operating as a single economic entity" and that there must be an "overall element of injustice or unfairness")).

effective imposition of that extraordinary outcome is warranted in the Debtors' cases.[13] To the contrary, the publicly available information to date demonstrates that the standards for substantive consolidation have not been met, because at all times creditors recognized that ATI and ATCW were separate and distinct entities, and dealt with them as such.[14]

17. That is most plainly apparent with respect to the ATI Note holders, who knowingly lent to a holding company and therefore accepted the risk that their claims would be structurally subordinated. The Debtors' filings with the Securities and Exchange Commission (the "SEC") – public information on which investors and entities doing business with the Debtors are expected to rely – always have stated clearly that the $650 million in bond debt was issued at the ATI level, while operations were conducted at the level of ATI's subsidiaries. For example, discussing the issuance of its $445 million in Senior Discount Notes pursuant to an exchange offer, ATI stated that:

> The Company [i.e., ATI] is a holding company and its principal assets consist of the common stock of its operating subsidiaries. The Company will rely upon dividends and other payments from its subsidiaries to generate the funds necessary to meet its obligations, including the payment of principal of and interest on the Notes. The subsidiaries, however, are legally distinct from the

[13] In the Second Circuit, courts have considered the following (non-exhaustive) list of factors in determining whether substantive consolidation is warranted in particular cases: (i) the presence or absence of consolidated financial statements; (ii) the unity of interest and ownership among various corporate entities; (iii) the degree of difficulty in segregating and ascertaining individual assets and liabilities; (iv) the transfers of assets without formal observance of corporate formalities; (v) the commingling of assets and business functions; (vi) the profitability of consolidation at a single physical location; and (vii) the disregard of legal formalities. See, e.g., In re Augie/Restivo Baking Co. Ltd., 860 F.2d at 518; see also Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446, 447-48 (2d Cir. 1964); In re Food Fair, Inc., 10 B.R.. 123, 126 (Bankr. S.D.N.Y. 1981). The Disclosure Statement does not contain a discussion of any of these factors.

[14] Nor have the Debtors shown that their books and records are so hopelessly entangled as to separately warrant substantive consolidation. See Augie/Restivo, 860 F.2d at 519 (opining that the factor analyzing the degree of entanglement of the debtor's affairs "involves cases in which there has been a commingling of two firms' assets and business functions" and that "[r]esort to consolidation in such circumstances, however, should not be Pavlovian. Rather, substantive consolidation should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets" of the debtor). Indeed, a review of the Debtors' bankruptcy schedules and statements of financial affairs shows that they were filed on an entity-by-entity basis in early September 2003, which would suggest that the Debtors are, in fact, able to segregate their books and records.

> Company and such subsidiaries will have no obligation, contingent or otherwise, to pay amounts due pursuant to the Notes or to make funds available for such payment. The Company's subsidiaries will not guarantee the Notes. The ability of the Company's subsidiaries to make such payments to the Company will be subject to, among other things, the availability of funds, the terms of such subsidiaries' indebtedness and applicable state laws. Claims of creditors of the Company's subsidiaries, including trade creditors, will generally have priority as to the assets of such subsidiaries over the claims of the holders of the Company's indebtedness, including the Notes. Accordingly, the Notes will be effectively subordinated to the liabilities (including trade payables and indebtedness under the Lease Facility) of the subsidiaries of the Company.

Allegiance Telecom, Inc. Form S-4 Registration Statement Under the Securities Act of 1933, dated March 31, 1998 (the "March 31, 1998 S-4"), at 19 (emphasis supplied). The March, 31, 1998 S-4 was amended from time to time, but the language regarding the structural subordination of the bondholders remained substantially the same. Compare, e.g., Amendment No. 3 to Form-S-4 Registration Statement Under the Securities Act of 1933, dated May 33, 1998:

> Substantially all of the Company's outstanding capital stock is held by Allegiance Telecom, L.L.C. ("Allegiance LLC"), which is principally controlled by the Fund Investors and the Management Investors. The Company is a holding company and its principal assets consist of the common stock of its operating subsidiaries. The Company will rely upon dividends and other payments from its subsidiaries to generate the funds necessary to meet its obligations, including the payment of principal of and interest on the Notes. The subsidiaries, however, are legally distinct from the Company and such subsidiaries will have no obligation, contingent or otherwise, to pay amounts due pursuant to the Notes or to make funds available for such payment. The Company's subsidiaries will not guarantee the Notes. The ability of the Company's subsidiaries to make such payments to the Company will be subject to, among other things, the availability of funds, the terms of such subsidiaries' indebtedness and applicable state laws. Claims of creditors of the Company's subsidiaries, including trade creditors, will generally have priority as to the assets of such subsidiaries over the claims of the holders of the Company's indebtedness, including the Notes. Accordingly, the Notes will be effectively subordinated to the liabilities (including trade payables) of the subsidiaries of the Company.

Id. at 20-21 (emphasis supplied). Substantially similar language was used by ATI in describing the structural subordination of its $205 million in Senior Notes. See, e.g., Prospectus Filed Pursuant to Rule 424(b)(4) dated July 2, 1998, at 15.

18. The Disclosure Statement sets forth none of these facts. Nor does it advise creditors that the Plan seeks to effect a result inconsistent with the Debtors' prior SEC filings – that although the SEC filings stated that the subsidiaries are legally distinct from ATI and would have no obligation to make payments on the ATI Notes, the Plan seeks to have the subsidiaries do precisely that. The Disclosure Statement also fails to advise creditors that the legitimate business expectations of unsecured creditors of the ATCW Debtors, such as KMC – which relied on the separateness of these entities and the absence of any ATI Note debt at the subsidiary levels – are being frustrated by the claim equalization under §§ 3.4 and 3.5 of the Plan, or that the bondholders at the ATI level, who knowingly purchased debt that was structurally subordinated to creditors of the ATCW Debtors, are slated to receive a windfall.[15]

19. For these reasons, the information in the Disclosure Statement in connection with the *de facto* substantive consolidation of ATI and ATCW, as well as the actual substantive consolidation of the ATCW Debtors, does not provide affected creditors with the requisite "adequate information" required by the Bankruptcy Code that would enable them intelligently to vote to accept or reject the Plan. As such, approval of the Disclosure Statement should be denied.

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[15] The combination of this prejudice to unsecured creditors of ATCW and windfall to the ATI Note holders suggests that substantive consolidation would not be appropriate even under the less restrictive Eastgroup Properties standards. See Eastgroup Props. v. Southern Motel Assoc., Ltd., 935 F.2d at 249 (holding that "a court must conduct a searching inquiry to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties") (internal quotation omitted).

B. The Disclosure Statement Does Not Adequately Disclose Information Regarding Ranges of Anticipated Recoveries to be Afforded to Unsecured Creditors

20. The second principal defect in the Disclosure Statement is even more blatant. For reasons that are entirely inexplicable, the Debtors fail to provide any disclosure with respect to the anticipated recoveries to be afforded to unsecured ATCW creditors based on the Plan that the Debtors have constructed. See, e.g., D.S. at § II.B. (p. 5), § V.B.7. (p. 23). It is hard to imagine any fact of more interest to creditors than the projected value of their distribution under the proposed Plan.

21. It may be that the Debtors intend to remedy this omission before the Disclosure Statement is circulated – but if so, one must ask why this critical information was not included before the Disclosure Statement was circulated for objection, so that ATCW creditors would know to what extent their potential recoveries are being diluted by the "compromise" which the Plan advocates, and perhaps been more active in objecting to this Disclosure Statement. It is difficult to believe that at this stage of the proceeding, the Debtors have not developed an estimate of the range of claims at ATCW, and thus should be able to provide an estimate of the recovery under the Plan, and compare that recovery to what these creditors would have received in the absence of the Plan's *de facto* substantive consolidation. (Indeed, the Debtors' own liquidation analysis (D.S., Ex. I, at 4) estimates ATCW Claims in Class 4 at $420.3 million, and the Disclosure Statement contains enough information as to asset values to permit the requisite computations to be made. Why were these computations not included in the Disclosure Statement draft circulated before the Disclosure Statement hearing?). Accordingly, before any Disclosure Statement is approved, the estimated recoveries under each alternative – the "compromise" and unconsolidated distribution of assets and liabilities on a debtor-by-debtor basis – should be set forth explicitly.

C. The Liquidation Analysis Provided in the Disclosure Statement is Misleading

22. As this Court is well aware, the "best interests of creditors" test requires that, with respect to each impaired class of claims or interests, each holder of such a claim or interest has accepted the plan or will receive property of a value not less than what such holder would receive if the debtor were liquidated. See 11 U.S.C. § 1129(a)(7); see also, Kane v. Johns-Manville Corp., 843 F.2d 636, 649 (2d Cir. 1988); In re The Leslie Fay Cos., Inc., 207 B.R. 764, 787 (Bankr. S.D.N.Y. 1997). To meet this requirement, the Debtors have advanced a liquidation analysis (D.S., Ex. I), which purports to show that after liquidation of the Debtors' unencumbered assets and properties and deduction of additional assumed chapter 7 costs, creditors will receive more under the Plan than they would in liquidation. See D.S., at § VII.C.4. (pp. 39-40); see also D.S., at Ex. I.

23. The Debtors' liquidation analysis bears on more than technical compliance with Bankruptcy Code requirements, because it is an important factor in persuading creditors whether they should vote for a particular plan. Essentially, creditors will compare their recoveries under the Plan – or at least will do so if and when the Debtors fill in the current blanks – to what they would receive in liquidation, which for ATCW Creditors is shown in Exhibit I as a 0.0% recovery. To the extent, therefore, that the liquidation analysis is incorrect or misleading, it has the potential to skew creditor votes.

24. That is precisely what the Debtors' liquidation analysis does. Even though this Court has already approved the Debtors' sale of their assets to XO and Level 3, the liquidation analysis assumes that none of these transactions take place, but instead, that the Debtors are dismembered and their assets are sold on a piecemeal forced sale to disparate buyers. Based on its fictional set of assumptions, the liquidation analysis (Ex. I to D.S. at 3) assumes gross liquidation proceeds of $627.7 million. By contrast, the XO proceeds alone, as estimated

in the Debtors' motion seeking approval of that transaction, was said to be worth $675 million.[16] When coupled with the $54 million to be received from Level 3 and the $273.5 million of cash on hand (Ex. I, p.2) the already-approved transactions will yield a gross sale value on liquidation of over $1 billion, even apart from the liquidation value of the assets which are to be part of Reorganized STFI!

25. In the face of these values, it is simply astounding that the Debtors' liquidation analysis assumes that the asset sales would yield only $627.7 million. There is no reason why a chapter 7 trustee could not consummate the pending XO and Level 3 transactions, and thereby obtain far more than the $627.7 million that the liquidation analysis assumes. See, e.g., 11 U.S.C. § 721 ("The court may authorize the trustee to operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate."). Moreover, it is likely that as part of a sale to XO and Level 3, the $100.2 million of wind-down costs and other expenses in liquidation (Ex. I, at 3) will be significantly reduced. But the Debtors' liquidation analysis ignores both of these factors, all in a fallacious attempt to show that the Plan, notwithstanding its unattractive "compromise" for ATCW Creditors, is better than a liquidation.

26. Attached hereto as Exhibit A is a simplified liquidation analysis, which assumes a sale of assets to XO and Level 3, in light of the current realities. Although presented

[16] See Debtors' Statement in Support of Motion for Orders Pursuant to Sections 105(a), 363, 365 and 1146(c) of the Bankruptcy Code (A) Approving the Sale to the Successful Bidder Free and Clear of All Liens, Claims and Encumbrances, (B) Authorizing the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases and (C) Granting Related Relief, Docket No. 969, filed on February 18, 2004, at ¶ 9 (discussing final XO bid of $675 million as having created significant additional value for the Debtors' chapter 11 estates). The Disclosure Statement (at p. 46) computes the value of the XO Common Stock to be received, based on a March 17 market price, at $241.9 million, which when coupled with the $311.2 million received in cash (D.S., at 17), yields a total value from XO of $553.1 million compared with the $675 million originally presented by the Debtors. (The Disclosure Statement does not discuss this disparity or express any view as to the correct valuation of the consideration to be received from XO.).

on a highly conservative basis,[17] this analysis shows that absent substantive consolidation, ATCW creditors will receive a 59% recovery on their claims!

27. The failure of the Disclosure Statement to set forth an accurate liquidation analysis is intimately bound up with the proposed Plan "compromise" in another way. In order to meet the best interests of creditors test, the Debtor will have to show – even if the rest of Class 4 votes in favor of the Plan – that any objecting ATCW Creditor would receive less by litigating the *de facto* substantive consolidation than it would under the Plan. Cf. In re MCorp Fin., Inc., 160 B.R. 941, 961 (S.D. Tex. 1993) (valuation of current litigation necessary for court to approve proposed Chapter 11 liquidation plan that provided for settlement of such litigation; to the extent objections go to the settlement, in regards to the best interests test, under a liquidation the liquidating trustee would have to make an analysis whether to settle or to pursue the litigation). That would require the Court to consider the value of the potential litigation that is being settled. Although ordinarily this is a confirmation issue,[18] a disclosure statement is required to fairly advise creditors of the facts and issues that might give them a basis to object to confirmation. The Disclosure Statement, however, seeks to do precisely the contrary. Thus, the Debtors' liquidation analysis, like their entire discussion of the proposed "compromise," seeks to nip potential Plan objections in the bud by giving creditors the impression that even apart from the *de facto* substantive consolidation, ATCW Creditors will not receive any distribution under a liquidation scenario, so there is no point in their advancing a best interests of creditors objection at confirmation. The purpose of a disclosure statement is to inform creditors, not to stifle or

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[17] For example, the XO consideration is reduced by over $120 million in accordance with footnote 16 supra, and no value is assumed for liquidation of STFI assets.

[18] See infra n. 19 and accompanying text (discussing the extent to which this Court should consider such confirmation issues at this stage).

suppress their potential dissent. This Disclosure Statement, including its spurious liquidation analysis, seeks to do the latter, and for that additional reason should not be approved.

28. For all of the foregoing reasons, this Court should find that the Debtors' Disclosure Statement fails to satisfy the "adequate information" standards mandated by section 1125 of the Bankruptcy Code, and its approval should be denied.

II. THE PLAN IS UNCONFIRMABLE AS A MATTER OF LAW

29. In order for the Plan ultimately to be confirmed, the Debtors will be required to show that the Plan conforms to all of the requirements of section 1129 of the Bankruptcy Code. Although the Debtors are not required at a hearing on their Disclosure Statement to make any definitive showing on this issue, there is authority for the proposition that this Court may decline to approve such Disclosure Statement if its contents, or the contents of the Plan, reflect an inability to comply with the requirements of Section 1129.[19] On the other hand, KMC recognizes that other courts decline to consider "plan objections" at disclosure statement hearings, and prefer to defer those issues to confirmation.[20]

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[19] See, e.g., In re 266 Washington Assocs., 141 B.R. 275, 288 (Bankr. E.D.N.Y.), aff'd, 147 B.R. 827 (E.D.N.Y. 1992) ("A disclosure statement will not be approved where, as here, it describes a plan which is fatally flawed and thus incapable of confirmation." (citations omitted)); In re Century Inv. Fund VIII Ltd. P'ship, 114 B.R. 1003, 1005 (Bankr. E.D. Wis. 1990) ("If a plan is on its face nonconfirmable as a matter of law, then it is appropriate for the court not to approve the disclosure statement."); see also In re Atlanta West VI, 91 B.R. 620, 622 (Bankr. N.D. Ga. 1988) ("A court may refuse to approve a disclosure statement when it is apparent that the plan which accompanies the disclosure statement is not confirmable. This is to avoid engaging in a wasteful and fruitless exercise of sending the disclosure statement to creditors and soliciting votes on the proposed plan when the plan is unconfirmable on its face." (citations omitted)); In re S.E.T. Income Properties, III, 83 B.R. 791, 792 (Bankr. N.D. Okla. 1988) ("A clear showing that the plan is not confirmable justifies denial of the sufficiency of the disclosure statement to avoid the cost and delay of a fruitless venture"); In re Pecht, 53 B.R. 768, 769-70 (Bankr. E.D. Va. 1985) ("Thus, a clear showing in a proffered disclosure statement that the plan could not be confirmed justifies a court in denying approval of the disclosure [sic] [statement]. Submitting the debtor to the attendant expense of soliciting votes and seeking court approval on a clearly fruitless venture would be costly and it would unduly delay any possibility of a successful reorganization").

[20] See, e.g., In re Eastern Maine Elec. Coop., Inc., 125 B.R. 329, 333 (Bankr. D. Me. 1991) (noting that refusal to approve a disclosure statement based on non-confirmability of a plan is discretionary; whether a plan meets requirements for confirmation is usually answered at the confirmation hearing, but where the plan display fatal facial deficiencies or the stark absence of good faith, they may and should be addressed at the disclosure statement stage); In re Monroe Well Serv., Inc., 80 B.R. 324, 333 (Bankr. E.D. Pa. 1987) (finding that the court's power to disapprove of a disclosure statement even if it properly summarizes and provides adequate information regarding the plan,

30. KMC believes that the Plan will not comply with the standards for confirmation in a number of respects, each of which is tied to the lack of merit in the proposed "compromise." First, the limited description of the issues contained in the Disclosure Statement suggests that the "compromise" is not a fair one, and therefore does not comply with the standards for compromises under Rule 9019. Second, the Plan's substantive consolidation, both of the ATCW Debtors and effectively between ATI and ATCW, does not comport with the rigorous Second Circuit standards for such treatment. See discussion at ¶¶ 13-19, supra. Third, the Plan does not comply with the best interests of creditors test, when viewed from the standpoint of a proper liquidation analysis rather than the fallacious analysis contained in Exhibit I. Finally, the Plan discriminates unfairly against and is not fair and equitable with respect to the ATCW unsecured creditors, because its improper implementation of substantive consolidation works a drastic dilution of claims filed against ATCW and its subsidiaries in favor of the bondholder creditors of ATI, which bondholders dominate the Creditors' Committee that helped to hatch the "compromise" of Intercompany Claims.[21]

31. Resolution of the appropriateness of the purported "compromise" in the Plan is likely to be a complex matter, requiring extensive discovery and far more disclosure of the underlying facts that the Disclosure Statement provides. Thus, to the extent that this Court is prepared to consider "plan objections" at this time, it should defer the disclosure statement hearing so that discovery can be conducted, rather than allow solicitation of a plan which, when the facts be known, embodies a "compromise" that does not meet the minimal standards for

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(continued…)
where the court is convinced the plan could not be confirmed, must be used carefully so as not to convert the disclosure statement hearing into a confirmation hearing).

[21] There are also individual features of the Plan that also may be objectionable, but KMC is limiting its comments here to the key structural elements of the Plan which it believes would preclude its confirmation. Nothing herein is intended to waive KMC's rights to object to confirmation on any basis, including those discussed below, in the

confirmation. On the other hand, even if this Court prefers to defer "plan objections" to the time of the confirmation hearing, it should require at least a *prima facie* showing by the Debtors of the reasonableness of the proposed "compromise," require a full discussion of those issues in the Disclosure Statement – together with giving KMC and other ATCW Creditors the opportunity to draft and include a statement of why they believe the Debtors' analysis to be fallacious – and set a schedule for parties in interest to obtain discovery on these critical issues in due time to permit them to be fully and fairly litigated at the confirmation hearing.

CONCLUSION

32. In view of all of the foregoing, KMC respectfully submits that this Court should deny approval of the Disclosure Statement.

(continued…)
event this Plan is presented for confirmation.

WHEREFORE, KMC respectfully requests that this Court enter an order denying approval of the Disclosure Statement and granting such other and further relief as is just and proper.

Dated: New York, New York
April 13, 2004

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EXHIBIT A

Simplified Allegiance Liquidation Analysis
Based on XO and Level 3 Sales and No Substantive Consolidation

NOTES		
A	Gross Recovery	880.2
B	Chapter 7 Admin Claims	50.1
	Funds Available For Distribution	830.1

	Class	Claim	Recovery	%
	Administrative Claims	93.1	93.1	100%
	Professsional Fees	5.8	5.8	100%
	Priority Tax	3.8	3.8	100%
	Class 1	0.1	0.1	100%
	Class 2	0.3	0.3	100%
	Class 3 -- Secured	478.7	478.7	100%
C	Class 4 -- ATCW Unsec	420.3	248.3	59%
C	Class 5 -- ATI Unsec	668.7	0	0%

Notes

A Gross recovery comprised of $273.5 million in cash, $311.2 in cash from XO, assumed XO stock value of $311.2 million, and $54 million from Level 3. Does not consider liquidation value of STFI assets.

B Assumes Chapter 7 administrative expenses are 50% of the amounts in Exhibit I, in light of sale to XO and Level 3.

C Assumes no actual or de facto substantive consolidation