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Ira S. Dizengoff (ID-9980)
Philip C. Dublin (PD-4919)
Colin M. Adams (CA-2913)
Kenneth A. Davis (KD-9070)
Akin Gump Strauss Hauer & Feld LLP
590 Madison Avenue
New York, NY 10022
(212) 872-1000 (Telephone)
(212) 872-1002 (Facsimile)

Counsel to the Official Committee of Unsecured
Creditors of Allegiance Telecom, Inc., et al.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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

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OFFICIAL COMMITTEE OF UNSECURED CREDITORS' MEMORANDUM OF LAW IN SUPPORT OF CONFIRMATION OF DEBTORS' SECOND AMENDED JOINT PLAN OF REORGANIZATION PURSUANT TO CHAPTER 11 OF THE BANKRUPTCY CODE

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The Official Committee of Unsecured Creditors (the "Committee") of Allegiance Telecom, Inc., et al. ("Allegiance" or the "Debtors"), by and through its counsel, Akin Gump Strauss Hauer & Feld LLP, submits this memorandum of law (the "Memorandum")[1] in support of the Debtors' Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code (the "Plan"). In support of this Memorandum, the Committee respectfully represents as follows:

PRELIMINARY STATEMENT

1. The fundamental premise of chapter 11 is the reorganization of a debtor enterprise and deployment of estate resources to maximize recoveries for the debtor's creditor constituencies. A debtor's reorganization can be accomplished in many ways, including through the sale of the debtor's assets or the reorganization of the debtor as a going concern; both of these alternatives are applicable to these Debtors. Indeed, these Debtors are on the cusp of accomplishing precisely what Congress envisioned in enacting the Bankruptcy Code and legions of courts laud through the sale of substantially all of their assets to XO Communications, Inc. ("XO") and the reorganization of a valuable Debtor, Shared Technologies, Inc. ("STFI"), as a stand-alone going concern.

2. The Plan is the product of intense, complex and, at times, arduous negotiations among the Debtors and their major creditor constituencies, incorporates a compromise and settlement of myriad complex disputes, and at confirmation the Debtors will provide a certification that the Plan has been approved by both classes of creditors entitled to vote to accept or reject the Plan.

[1] By this Memorandum, the Committee joins and incorporates, as if fully set forth herein, the legal and factual assertions set forth in the Debtors' (Memorandum of Law in Support of Confirmation of the Debtors' Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code.)

3. The foundation of the Plan is the compromise and settlement (the "Compromise and Settlement") reached among the Debtors, the Committee, the Secured Lenders and the ATI Notes Trustee (each, as defined below) and the substantive consolidation of the ATCW Debtors (as defined below). The parties concluded that based on the inherent uncertainty of potential outcomes of material, complex litigation related to among other things, the Debtors' inability to accurately account for historical intercompany payables and receivables (the "Intercompanies") (other than a known $1.9 billion payable from ATCW (as defined below) to Allegiance Telecom, Inc. ("ATI"), alleged violations of the Indentures (as defined below) and the Prepetition Credit Agreement (as defined below) in connection with the granting of liens and guarantees to the Secured Lenders, claims relating to the potential equitable subordination of the Secured Lenders' claims and the fact that the Debtors ran their operating businesses as a single consolidated entity, the Plan was the best means of maximizing value for all of the Debtors' creditors.

4. The dissenters claim, inaccurately, that it was inappropriate for the Debtors to settle claims that (i) the Debtors' noteholders should have received equal and ratable liens and guarantees under the terms of the Indentures as a result of certain liens and guarantees that were provided after the execution of those Indentures to the Debtors' Secured Lenders and (ii) certain intercompany claims owing from one Debtor to another should have been recharacterized as capital contributions. These dissenters make no more than self-interested arguments that would increase their recoveries, ignore the fact that they threaten litigation that could jeopardize the asset sale which is the very foundation of the Plan and the basis for their receipt of any recovery

at all,[2] and as further discussed below, ignore significant evidence that undermines their litigation positions.

5. To that end, the Compromise and Settlement and agreed upon substantive consolidation of the ATCW Debtors:

- resolves the treatment of ATI Unsecured Claims, which in turn resolves;
  - the ATI Notes Trustee's assertions that the granting of certain liens and guarantees by the Debtors to the Secured Lenders violated the negative pledge provisions of the Indentures and, thus, the Noteholders (as defined below) were entitled to equal and ratable liens on the assets of and guarantees from each of the Debtors;
  - issues in connection with the book entry records reflecting that ATCW was indebted to ATI in the amount of approximately $1.9 billion on account of an intercompany debt;
- resolves the treatment of ATCW Unsecured Claims, which in turn resolves;
  - litigation regarding the allowance or disallowance of Intercompanies and attendant fraudulent conveyance, equitable subordination, recharacterization and preference causes of action and available remedies among the various ATCW Debtors; and
- resolves claims under the Prepetition Credit Agreement, which in turn resolves;
  - potential litigation regarding the potential equitable subordination of the Secured Lenders' claims.

[2] Deposition of Mark Tresnowski, General Counsel to the Debtors, May 26-27, 2004 at 128:18-25; 129:2-6 (the "Tresnowski Deposition").

6. Accordingly, the Debtors believe, and the Committee agrees, that the expedited resolution of these complex legal and factual disputes benefits the estates by avoiding the time, delay and expense of litigation whose outcome is uncertain and which would have severe negative consequences for the Debtors and the value of their estates.

BACKGROUND

7. On May 14, 2003 (the "Petition Date"), each of the Debtors filed with this Court a voluntarily petition for relief under chapter 11 of title 11 of the Unites States Code (the "Bankruptcy Code").

8. The Debtors continue to operate their businesses and manage their properties as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. The chapter 11 cases have been procedurally consolidated for administrative purposes.

9. On May 28, 2003, pursuant to section 1102 of the Bankruptcy Code, the United States Trustee appointed the Committee.

The Debtors

10. Allegiance is a facilities based national local exchange carrier that provides integrated telecommunications products and services to small and medium-sized business customers, large businesses (i.e., national customers with multiple locations), governmental entities, national service providers and other institutional users. Allegiance offers its customers a variety of services, including (i) local and long distance voice services, (ii) broadband and other Internet and data services, (iii) integrated local long distance and Internet access, (iv) services to other regional and national service providers, and (v) customer premises equipment sales and maintenance services.

11. As of December 31, 2003, Allegiance served more than 100,000 business customers in major markets throughout the United States and employed approximately 3,000 people.

The Debtors' Business Operations

12. Allegiance was launched in 1997 in order to establish a nationwide network, focused on small to medium-sized business enterprises. Following an initial business plan proposing entry into 24 of the largest metropolitan areas in the United States, management expanded the Allegiance's business plan to (i) increase the total number of target markets to 36, (ii) increase Allegiance's service area, i.e., its collocation "footprint" in its original 24 markets, and (iii) acquire long-term rights to use certain "dark fiber rings" to replace certain network elements leased by the Debtors from incumbent local exchange carriers ("ILECs").

13. Allegiance also grew through various acquisitions. In December 2001, Allegiance acquired certain assets of Intermedia Business Internet, which allowed Allegiance to (i) become a Tier 1 Internet access provider, (ii) provide the capability to transmit large quantities of data at high-speeds over the Internet to and from a customer's premises, (iii) efficiently exchange traffic with other Internet backbone providers giving Allegiance greater control over its Internet access, and (iv) leverage its local service presence to provide additional services to its target market. In June 2003, Allegiance acquired certain assets of STFI, which allowed it to, among other things, (i) add customer premises equipment sales, installation and maintenance to Allegiance's portfolio of products and services, and (ii) enhance Allegiance's target market of small to medium-size business enterprises.

14. As of December 31, 2003, the Debtors had approximately $282.2 million of unrestricted cash on hand, consolidated assets totaling approximately $1.139 billion and

consolidated liabilities totaling approximately $1.337 billion. For the twelve months ending December 31, 2003, the Debtors, on a consolidated basis, reported revenues of approximately $777.3 million and net losses of approximately $360 million.

15. Allegiance provides telecommunications services in at least 36 major metropolitan areas across the United States.

The Debtors' Prepetition Capital Structure

16. Capital Stock. ATI, the ultimate parent company of the remaining Debtors, has two classes of authorized stock: (a) 750,000,000 shares of common stock, with par value of $0.01 per share and (b) 1,000,000 shares of preferred stock, with par value of $0.01 per share. As of December 31, 2003, ATI had (i) 120,350,803 shares of publicly traded common stock issued and outstanding, with 295 registered holders and at least 20,000 beneficial owners, and (ii) no shares of preferred stock outstanding. ATI owns 100% of the capital stock of Debtor Allegiance Telecom Company WorldWide ("ATCW"), and ATCW directly or indirectly owns 100% of the capital stock of each of the remaining Debtors (the "Subsidiaries" and, collectively with ATCW, the "ATCW Debtors").

17. The Prepetition Notes. In 1998, ATI issued two series of notes: (i) 11¾ % Senior Discount Notes, due on February 15, 2008 (the "Senior Discount Notes"); and (ii) 12? % Senior Notes, due on May 15, 2008 (the "Senior Notes" and, together with the Senior Discount Notes, the "Notes"). The Senior Discount Notes were issued under that certain Indenture (the "11¾ % Senior Discount Note Indenture"), dated as of February 3, 1998, between ATI and The Bank of New York, as Indenture Trustee (the "ATI Notes Trustee"). The Senior Notes were issued under that certain Indenture, dated as of July 7, 1998 (the "12? % Senior Note Indenture" and, together

with the 11¾ % Senior Discount Note Indenture, the "Indentures"), between ATI and the ATI Notes Trustee, as Indenture Trustee.

18. Each Indenture places restrictions on, among other things, the Debtors' ability to encumber assets and grant guarantees: (i) section 4.07[3] of each Indenture provides that (a) Restricted Subsidiaries (as defined in the Indentures) cannot guarantee indebtedness of ATI which is *pari passu* with the Notes unless such Restricted Subsidiaries simultaneously equally and ratably guarantee payment of the Notes to the holders of the Notes (the "Noteholders"), and (b) such Restricted Subsidiaries waive rights of reimbursement, indemnity or subrogation against ATI and other Restricted Subsidiaries resulting from performance under the guarantee and (ii) section 4.09 of each Indenture provides that no liens (with a variety of exceptions) may be granted by ATI or its subsidiaries, unless the Notes are equally and ratably secured.[4]

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[3] Section 4.07 of each Indenture provides:

> Limitation on Issuances of Guarantees by Restricted Subsidiaries. [ATI] will not permit any Restricted Subsidiary, directly or indirectly, to Guarantee any Indebtedness of [ATI] which is pari passu with or subordinate in right of payment to the Notes ("Guaranteed Indebtedness"), unless (i) such Restricted Subsidiary simultaneously executes and delivers a supplemental indenture to this Indenture providing for a Guarantee (a "Subsidiary Guarantee") of payment of the Notes by such Restricted Subsidiary and (ii) such Restricted Subsidiary waives and will not in any manner whatsoever claim or take the benefit or advantage of, any rights of reimbursement, indemnity or subrogation or any other rights against the [ATI] or any other Restricted Subsidiary as a result of any payment by such Restricted Subsidiary under its Subsidiary Guarantee; provided that this paragraph shall not be applicable to any Guarantee of any Restricted Subsidiary that existed at the time such Person became a Restricted Subsidiary and was not Incurred in connection with, or in contemplation of, such Person becoming a Restricted Subsidiary. If the Guaranteed Indebtedness is (A) pari passu with the Notes, then the Guarantee of such Guaranteed Indebtedness shall be pari passu with, or subordinated to, the Subsidiary Guarantee or (B) subordinated to the Notes, then the Guarantee of such Guaranteed Indebtedness shall be subordinated to the Subsidiary Guarantee at least to the extent that the Guaranteed Indebtedness is subordinated to the Notes.

[4] Section 4.09 of each Indenture provides:

> Limitation on Liens. [ATI] will not, and will not permit any Restricted Subsidiary to, create, incur, assume or suffer to exist any Lien on any of its assets or properties of any character (including, without limitation, licenses), or any shares of Capital Stock or Indebtedness of any Restricted Subsidiary, without making effective provision for all of the Notes and all other amounts due under this Indenture to be directly secured equally and ratably with (or, if the obligation or liability to be secured by such Lien is subordinated in right of payment to the Notes, prior to) the obligation or liability secured by such Lien [...].

19. The Prepetition Credit Agreement. Approximately two years after the issuance of the Notes pursuant to the Indentures, and prior to the Petition Date, ATCW entered into a certain Credit and Guaranty Agreement, dated as of February 15, 2000, as amended as of November 27, 2002 (the "Prepetition Credit Agreement"), between ATCW, as borrower, the remaining Debtors (including ATI), as guarantors, Goldman Sachs Credit Partners L.P., as syndication agent and sole lead arranger, and the lenders from time to time party thereto (the "Secured Lenders"). As of the Petition Date, the amount outstanding under the Prepetition Credit Agreement was approximately $465.3 million[5]. The Debtors pledged substantially all of their assets as collateral under the Prepetition Credit Agreement, including: (a) the capital stock of ATCW; and (b) substantially all of the assets of ATCW and the Subsidiaries, including the capital stock owned by ATCW in each of the Subsidiaries.

Events Leading to the Commencement of the Chapter 11 Cases

20. On November 27, 2002, ATI and its Secured Lenders entered into a certain First Amendment to the Prepetition Credit Agreement (the "Amendment"). Pursuant to the Amendment, the Debtors obtained a moratorium on defaults under their financial covenants through April 30, 2003. In exchange for the Amendment, ATI agreed, among other things, (a) that an event of default would occur on April 30, 2003 unless it reduced its long term debt to a level not to exceed $645 million, and (b) to repay $15 million to the Secured Lenders on account of debt owed under the Prepetition Credit Agreement.

21. After entering into the Amendment, the Debtors commenced negotiations with the Secured Lenders to consummate a permanent restructuring. In connection with those

[5] In accordance with the terms of this Court's Second Amended Final Order Authorizing Use of Cash Collateral by Consent, dated December 18, 2003 (as extended by stipulation on March 1, 2003), the amount outstanding under the Prepetition Credit Agreement is approximately $477.8 million.

negotiations, the Debtors also commenced negotiations with an ad hoc committee of Noteholders, comprised of certain holders of the Senior Notes and the Senior Discount Notes (the "Ad Hoc Committee"). The Debtors, the Secured Lenders and the Ad Hoc Committee were not able to reach an agreement concerning the permanent restructuring prior to the deadline of April 30, 2003. On April 29, 2003, to avoid the occurrence of certain events of default under the Prepetition Credit Agreement, the Debtors and the Secured Lenders entered into a forbearance agreement (the "Forbearance Agreement"), which expired on May 15, 2003. The Forbearance Agreement provided for, among other things, a pay down of $5 million of principal owed under the Prepetition Credit Agreement and the forbearance by the Secured Lenders on account of defaults under the Prepetition Credit Agreement.

22. After entering into the Forbearance Agreement, the Debtors continued their negotiations with the Secured Lenders and the Ad Hoc Committee. However, the parties were unable to reach an agreement prior to the expiration of the term of the Forbearance Agreement. Consequently, the Debtors commenced these chapter 11 cases.

Post-Petition Events

23. The Stand-Alone Plan. Shortly after the Petition Date, the Debtors began negotiating with the Secured Lenders regarding a stand-alone restructuring of the Debtors' businesses. Following discussions in late May 2003 between the Debtors and the Secured Lenders concerning the terms of a stand-alone restructuring, on June 11, 2003, the Debtors provided the Secured Lenders with a term sheet for such a stand-alone restructuring. After further negotiations, the Debtors and the Secured Lenders agreed to the terms of a stand-alone restructuring plan. After obtaining the support of the Secured Lenders, the Debtors presented the plan to the Committee with the intention of obtaining the Committee's support for the Plan. The

Committee did not support the stand-alone plan, as the terms of the stand-alone plan provided unsecured creditors with a *de minimis* recovery, if any.

24. The XO Sale. After consulting further with the Secured Lenders and the Committee (and in light of the Committee's position that the proposed stand-alone plan was unacceptable), the parties collectively determined that the Debtors could obtain the greatest value for their creditors through a sale transaction. Following cursory discussions with parties potentially interested in purchasing substantially all of the Debtors' assets, on October 17, 2003, the Debtors' financial advisors sent a letter (the "Stalking Horse Letter") to each of the three most interested potential bidders inviting them to submit non-binding offers for the Debtors' businesses. On October 21, 2003, in response to the Stalking Horse Letter, two of the three parties (the "Potential Stalking Horse Bidders") submitted non-binding offers to purchase substantially all of the Debtors' businesses. Thereafter, the Debtors commenced negotiations with each of the Potential Stalking Horse Bidders with respect to an asset purchase agreement.

25. After extensive deliberation regarding the merits and risks of both asset purchase agreements, the Debtors selected Qwest Communications International, Inc. ("Qwest") as the stalking horse bidder. On December 18, 2003, the Debtors executed an asset purchase agreement with Qwest (the "Qwest Purchase Agreement"). On January 15, 2004, this Court entered an order (the "Bid Procedures Order") establishing the bidding procedures and the date of an auction for the sale of the Debtors and approving the break-up fee and related bid protections contemplated in the Qwest Purchase Agreement.

26. On February 9, 2004, the Bid Deadline established pursuant to the Bid Procedures Order, XO, an independent broadband telecommunications services provider, submitted the only qualified bid for the purchase of substantially all of the Debtors' assets.

27. On February 12, 2004, the Debtors commenced an auction for substantially all of the Debtors' assets. At the conclusion of the auction, after over twenty hours of bidding, the Debtors, in consultation with the Secured Lenders and the Committee, determined that XO had submitted the "highest and best" bid for the Debtors' assets. Following a hearing on February 19, 2004, on February 20, 2004, this Court entered an order (the "Sale Order"), which among other things, approved the sale of certain of the Debtors' assets to XO (the "Sale") in accordance with the terms and conditions set forth in the Sale Order and in the purchase agreement between the Debtors and XO (the "Purchase Agreement").

28. In consideration for the acquired assets, and subject to the terms and conditions of the Purchase Agreement, XO agreed to, among other things, (a) pay to ATI $311,200,000 in cash, subject to certain adjustments; (b) deliver 45,380,000 shares of XO common stock (the "XO Common Stock"), subject to certain adjustments; and (c) assume certain liabilities (collectively, the "Purchase Price"). It is anticipated that the Sale will be consummated as soon as possible after confirmation of the Plan.

Negotiations Regarding the Compromise and Settlement

29. Prior to the Sale and thereafter, the Committee engaged in arm's-length negotiations with the Debtors, the Secured Lenders and the ATI Notes Trustee regarding various issues that would need to be considered in the formulation of the terms of a confirmable chapter 11 plan. The negotiations centered on the parties' desire to propose a consensual plan of reorganization that would (a) have the support of the Debtors' primary creditor constituencies and (b) adequately account for the claims and potential claims of various constituents, with respect to the following issues (collectively, the "Settlement Issues"):

- whether the ATI Notes Trustee could assert a colorable claim, on behalf of the Notes, for an equitable lien on certain of the Debtors' assets as a result of alleged violations of the Indentures related to the Prepetition Credit Agreement;

- whether the ATI Notes Trustee could assert a colorable claim, on behalf of the Notes, for equal and ratable guarantees from each of the ATCW Debtors; and
- the enforceability of certain Intercompanies (and the attendant fraudulent conveyance and preference causes of action incorporated within that analysis).

The ATI Notes Trustee's Claims

30. The ATI Notes Trustee, on behalf of the Noteholders, advanced several arguments in support of the position that, as a result of violations of the Indentures (a) the Noteholders are entitled to guarantees of the amounts due under the Notes from each of the ATCW Debtors and (b) the Noteholders are entitled to liens on substantially all of the Debtors' property. The Debtors and the Secured Lenders disputed the ATI Notes Trustee's arguments. The Committee reviewed each of the allegations made by the ATI Notes Trustee (and the Debtors and Secured Lenders' contentions to the contrary) and determined that (a) while there may have been technical violations of the Indentures, the litigated outcome of the appropriate remedy available to the ATI Notes Trustee (i.e., whether liens and/or guarantees should be granted to the ATI Notes Trustee) was unclear and (b) to the extent the $1.9 billion claim from ATCW to ATI was allowed (and not otherwise recharacterized as an equity contribution), the recoveries to the Debtors' non-Noteholder unsecured creditors could be greatly diminished.

31. Incurrence of Additional Debt in Violation of the Indentures. The ATI Notes Trustee alleges its secured claim on the argument that (a) both of the Indentures, in Section 4.03, and the Prepetition Credit Agreement, limit the amount of borrowing (with certain exceptions not applicable here) under the Prepetition Credit Agreement to $100 million other than for equipment, inventory or network assets (collectively, "Capital Expenditures"), (b) in September 2001 and July 2002, ATCW borrowed an aggregate of $485.3 million under the Prepetition Credit Agreement, and subsequently repaid $20 million, (c) at least $216.8 million of the $270 million of the Debtors' cash on hand as of June 2003 constituted borrowings under the

Prepetition Credit Agreement, and (d) since September 2001, total Capital Expenditures have been $248.5 million and anticipated Capital Expenditures in the future were expected to be approximately $50 million per annum[6] as a result at least $116.8 million of the funds the Debtors borrowed in July 2002 were not incurred to finance Capital Expenditures:[7] the ATI Notes Trustee thus asserts that the Debtors' incurrence of indebtedness in excess of $100 million for non-Capital Expenditures and for the liens and guarantees granted in respect thereof, violated the Indentures and the Prepetition Credit Agreement.

32. Issuance of Guaranties In Violation of the Indentures' Equal and Ratable Clause. ATI and ATCW's domestic subsidiaries are guarantors under the Prepetition Credit Agreement, not just of the obligations of ATCW, but also the obligations of all other guarantors, including each of the Restricted Subsidiaries (as defined in the Indentures) and ATI.

33. The ATI Notes Trustee claims that the Debtors violated section 4.07 of each Indenture, which, as stated above, provides that the Restricted Subsidiaries cannot guarantee indebtedness of ATI which is *pari passu* with the Notes unless such Restricted Subsidiaries simultaneously equally and ratably guarantee payment of the Notes.

34. While ATI's guarantee of its Subsidiaries' obligations under the Prepetition Credit Agreement is secured by a pledge of ATI's ownership interest in ATCW's capital stock, ATI's guarantee of ATCW's obligations under the Prepetition Credit Agreement is otherwise *pari passu* with all of ATI's other general obligations. Accordingly, the ATI Notes Trustee asserts that since the Subsidiaries guaranteed ATI's guarantee obligations in connection with the

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[6] Since September 2001, the Debtors have used $100 million in borrowings under the Prepetition Credit Agreement for general working capital purposes.

[7] $465 million (the amount lent) *less* $248.5 million (the amount used for Capital Expenditures) *less* $100 million (the permitted non- Capital Expenditure indebtedness) leaves $116 million as improperly incurred indebtedness.

Prepetition Credit Agreement, the Secured Lenders acquired guarantees from the Restricted Subsidiaries in violation of the Indentures' equal and ratable clause.

35. Additionally, the pledge and security agreement between the Secured Lenders and the Debtors (the "Pledge and Security Agreement") entered into in connection with the Prepetition Credit Agreement, pursuant to which the pledges of security were made to the agent on behalf of the Secured Lenders, provided that ATCW would pledge its assets to secure the Subsidiaries' obligations (including such Subsidiaries' guarantees of ATI's guarantee under the Prepetition Credit Agreement). According to the ATI Notes Trustee, this pledge of ATCW's assets operated as a guarantee of ATI's guarantee by ATCW. In addition to arguing that the Notes are guaranteed by the Subsidiaries, the ATI Notes Trustee thus also argues that because ATCW is a Restricted Subsidiary (as defined in the Indentures), ATCW should have guaranteed the Notes.

36. Issuance of Liens in Violation of the Indentures. As stated above, section 4.09 of each Indenture provides that no liens (with a variety of exceptions) may be granted by ATI or its subsidiaries, unless the Notes are equally and ratably secured. According to the ATI Notes Trustee, the exception that ATI relied upon to grant liens to the Secured Lenders is a clause which permits pledges of the stock and assets of Restricted Subsidiaries securing indebtedness of such Restricted Subsidiaries permitted under Section 4.03 of the Indenture, which includes only: (i) a Restricted Subsidiary's guarantee of the Prepetition Credit Agreement, if permitted and (ii) direct borrowings by a Restricted Subsidiary (only ATCW was a borrower under the Prepetition Credit Agreement).

37. ATCW pledged all of its assets to secure not only its obligations under the Prepetition Credit Agreement, but also the guarantee obligations of the Subsidiaries. According

to the ATI Notes Trustee, this is not permitted under the Indentures unless the Notes are equally and ratably secured and, therefore, the negative pledge covenants in the Indentures were violated and, thus, the Noteholders are entitled to equitable liens on each of the Debtor's assets.

38. In addition, the ATI Notes Trustee has asserted that ATCW violated the debt incurrence provisions of the Prepetition Credit Agreement and the Indentures by borrowing more than $100 million for non-Capital Expenditures; the excess could not be pledged to the banks without equally and ratably securing the Notes.

The Debtors' Analysis of the ATI Notes Trustee's Claims

39. In connection with the negotiations concerning the Compromise and Settlement, the Debtors independently analyzed the validity of the ATI Notes Trustee's claims. During the course of this analysis, the Debtors drafted a memorandum describing the results of their own internal due diligence. See Memorandum from Mark Tresnowski To File, dated June 20, 2003, Re: Covenant Analysis (the "Tresnowski Covenant Analysis"). The Tresnowski Covenant Analysis contains the Debtors' covenant-by-covenant analysis of the restrictions under the Indentures and how they impact the Prepetition Credit Agreement.

The Debtors' Investigation of Guaranty Claims

40. The Debtors found that the following factors were supportive of the ATI Notes Trustee's claim:

- certain terms of the Prepetition Credit Agreement are extremely broad and could be construed to create a guarantee by each Restricted Subsidiary not only of ATCW's indebtedness under the Prepetition Credit Agreement but also of ATI's obligations under its own guarantee;
- ATI's guarantee of obligations under the Prepetition Credit Agreement is *pari passu* with its obligations under the Indentures, making such guarantee impermissible under the Indentures; and
- the possibility that the Prepetition Credit Agreement does create a guarantee by each of the ATCW Debtors of the guarantee of ATI on the Debtors' obligations to

> the Secured Lenders under the Prepetition Credit Agreement and that the Subsidiaries should also have guaranteed the Notes.

Tresnowski Covenant Analysis at 3.

41. The Debtors further found that the following positions undermined the strength of the ATI Notes Trustee's argument:

- limitations contained in section 4.07 of the Indentures, with respect to the issuance of guarantees by Restricted Subsidiaries, do not apply to upstream guarantees (guarantees from a subsidiary to its parent) granted under the Prepetition Credit Agreement;
- the upstream guarantees under the Prepetition Credit Agreement were not guaranteeing ATI's indebtedness, but rather only Restricted Subsidiary indebtedness; and
- the Debtors dispute whether the ATCW Debtors also guaranteed ATI's guarantee under the Prepetition Credit Agreement.

Tresnowski Covenant Analysis at 4-5.

<u>The Debtors' Investigation of the Issuance of Liens in Violation of the Indentures</u>

42. During the course of the negotiations over the Compromise and Settlement, the Debtors disputed the ATI Notes Trustee's assertions that violations of the Indentures and the Prepetition Credit Agreement provided the Noteholders with an equitable lien in the Debtors' assets. The Debtors' analysis led them to believe that the Secured Lenders' liens did not violate the terms of the Indentures as the Debtors relied on section 4.09(v) of the Indentures, the broadest exception to the general prohibition against encumbrances, to grant the liens to the Secured Lenders. Pursuant to this exception, the Debtors believe that (i) ATCW may grant a lien on its own stock, property and assets (which includes the stock of the third-tier subsidiaries held by ATCW) and (ii) each Subsidiary may grant a lien on its stock, property and assets to secure its indebtedness as a guarantor.

43. The Debtors also asserted that, in the case of ATCW, its liens to secure its own debt are clearly valid (and valuable because the Debtors asserted that ATCW holds substantially all of the assets of the Debtors' enterprise) while its liens to secure the obligations of the Subsidiaries may not be valid. As a result, the Debtors believe that the guarantees of the Subsidiaries are not collateralized by property of ATCW because they are not permitted to be under section 4.09(v) of the Indentures. See Tresnowski Covenant Analysis at 4-5.

44. The Debtors also asserted that the Indentures permit liens on up to $100.0 million of debt secured by stock of the Restricted Subsidiaries. The Debtors further concluded that the Indentures (a) do not permit the Company or any Restricted Subsidiary to grant a security interest in property or assets not acquired with such indebtedness, (b) do permit, for example, a lien on the property or assets of a Texas Subsidiary to secure indebtedness incurred to finance the acquisition of property or assets by a California Subsidiary, (c) would not permit a lien on any property or assets *currently* owned by ATI or any of the Subsidiaries and (d) would, however, permit the specific third-tier subsidiaries which receive money borrowed under the Prepetition Credit Agreement to grant a lien on the property and assets acquired with such money. See Tresnowski Covenant Analysis at 5-7.

Intercompany Claims

45. In the exercise of its fiduciary duty, the Committee and its advisors, as well as the Debtors, conducted due diligence with respect to the Debtors' books and records and general accounting practices. The Committee's investigation included meetings with certain members of the Debtors' management, including those with primary responsibility for the Debtors' accounting function and an analysis of a consolidating balance sheet prepared at the Committee

professional's request. During the course of this investigation, the Committee's professionals uncovered the following based upon analysis of the Debtors' books and records:

- ATI is owed approximately $1.9 billion by various other Debtor entities based on the Debtors' consolidating balance sheet as of September 30, 2003, but this obligation is only reflected by a book entry and not an intercompany note.

- Intercompanies relating to periods prior to 1999 were recorded on a legacy accounting system (the "Peachtree System") that the Debtors cannot currently access. Accordingly, while net intercompany payables and receivables are reflected in the current accounting system, they cannot be tied to general ledger entries prior to 1999.

- The limited number of identifiable Intercompanies were recorded in the general ledger as intercompany accounts receivable ("A/R"), accounts payable ("A/P") or, in some situations, as intercompany notes.[8]

- Intercompanies were recorded on a net basis (i.e., the system maintained a running balance that netted the intercompany A/R and A/P transactions between two given legal entities). As a consequence, it would be extremely difficult and time consuming to unravel and research the numerous transactions embedded in particular intercompany A/R and A/P balances to determine the appropriate characterization of such obligations;

- Certain of the ATCW Debtors filed regular state tax returns that included income statements and balance sheets with intercompany balances, with the income statements of various operating companies including charges for interest on intercompany notes.

- The Debtors maintain a bank account at the ATI level that management describes as an investment account. ATI typically transferred cash down to Allegiance Telecom Service Corporation ("ATSC") to fund disbursements on behalf of various operating subsidiaries. Once cash was transferred to ATSC, ATSC disbursed cash on behalf of the operating subsidiary to meet certain obligations (i.e., network expenses/capital expenditures).

- Transfers of cash down to ATSC from ATI were recorded in the intercompany A/R and A/P accounts as a payable from ATSC to ATI. No interest was charged on funds transferred from ATI. ATSC recorded a corresponding intercompany A/R from the operating subsidiary on account of the disbursement.

- The consolidating balance sheet provided to the Committee's financial advisors required over three weeks to develop. This was the first time that the Debtors generated consolidating financial information.

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[8] Most obligations between ATCW and the Subsidiaries that were booked as notes have associated interest charges.

46. Based on its investigation, the Committee concluded that it is unclear whether the transactions underlying the majority of such Intercompanies should be characterized as (i) capital contributions from ATI to the ATCW Debtors or (ii) loans to the ATCW Debtors.

47. Having reviewed the issues raised by the Committee, the Debtors concluded that the determination of the true nature of the Intercompanies would require a highly complex and, potentially, impossible analysis. For many of the reasons described above, the Debtors determined that it would be incredibly difficult to accurately reconstruct and appropriately document the Intercompanies, particularly in light of (i) personnel changes that were limiting institutional memory and (ii) the fact that the Intercompanies were incompletely documented.

The Committee's Analysis of the ATI Notes Trustee's Claims and Potential Recoveries

48. At the time the Committee undertook its analysis of the proposed Compromise and Settlement, the Committee consisted of five members, including two representatives of trade creditors (one of whom, however, had stated its intention to resign soon from the Committee pending assumption of its prepetition contract with the Debtors, as modified), two representatives of holders of ATI Notes, and the ATI Notes Trustee.

49. The Committee held several meetings and teleconferences during the course of negotiations over the terms of the Compromise and Settlement, during which the members of the Committee considered various compromise and settlement proposals. Counsel to certain individual Committee members attended each meeting. Prior to these meetings, the Committee's legal and financial professionals prepared numerous legal and factual memoranda for the members of the Committee on various topics relevant to the Compromise and Settlement, which were distributed to members of the Committee and their respective counsel. On several occasions, members of the Committee requested additional information and research from the

Committee's professionals on specific issues related to the various compromise and settlement proposals presented to the Committee. The Committee's professionals responded to each of these inquiries as appropriate. As a result of these meetings, and further discussions and negotiations with the Debtors, the Committee voted unanimously, with one member abstaining, to support the terms of the Compromise and Settlement.

50. In determining to approve the Compromise and Settlement, the Committee analyzed various recovery scenarios for the Debtors' unsecured creditor constituencies based on a variety of potential outcomes of the assertions made by the ATI Notes Trustee and issues related to the treatment of Intercompanies based on all information available to the Committee at the time. The Committee determined that in the event the assertions made by the ATI Notes Trustee as to the alleged violations of the Indentures were accurate, the remedy available to the Noteholders as a result of the violations of the Indentures was uncertain. The Committee was likewise uncertain as to the potential outcome of litigation related to the Intercompanies. With all of the information available to it at the time, the Committee evaluated the following litigation outcomes, among others:

- If all trade claims, rejection damages claims and capital lease deficiency claims were treated as structurally senior to the Notes and the transactions underlying the Intercompanies were treated as capital contributions, such Intercompanies would be in the nature of equity interests, and, thus, (a) the Noteholders would receive only the residual value of the ATCW Debtors' assets, for a total recovery of between 38.2% and 55.7%, while (b) general unsecured creditors would be paid in full.

- If the Noteholders prevailed in their litigation, resulting in the Noteholders receiving a secured claim equal to $116.8 million, and the Noteholders' deficiency claims were treated as *pari passu* with trade claims, rejection damages claims and capital lease deficiency claims, and all Intercompanies were cancelled, (i) Noteholders would receive between 45.1% and 59.2% of their allowed claims while (ii) general unsecured creditors would receive between 33.6% and 50.7% of their allowed claims.

- If the trade claims, rejection damages claims and capital lease deficiency claims were treated as structurally senior to the Notes, and assuming the $1.9 billion of Intercompanies owing from the ATCW Debtors to ATI were valid, (a) the Noteholders

would receive between 46.8% and 61.2% of their allowed claims and (b) the general unsecured creditors would receive between 16.6% and 21.7 % of their allowed claims.

- In the event that the Noteholders prevailed in their litigation, the Noteholders would receive a pro rata secured claim of $116.8 million, and assuming the $1.9 billion of Intercompanies owing from the ATCW Debtors to ATI were valid and all trade claims, rejection damages claims and capital lease deficiency claims were treated as structurally senior to the Notes, (a) the Noteholders would receive between 47.4% and 61.2% of their allowed claims and (b) general unsecured creditors would receive between 10.7% and 15.7% of their allowed claims.

- If all unsecured creditors were treated *pari passu* and Intercompanies were cancelled, (a) the Noteholders would receive between 44% and 58.6% of their allowed claims and (b) general unsecured creditors would receive between 44% and 58.6% of their allowed claims.

51. Under each of the potential recovery scenarios analyzed by the Committee there would have been sufficient value to cover the claims of the Secured Lenders in full.

52. As a result of the Compromise and Settlement, among other things, the Debtors formulated and filed the Plan, which is supported by the Secured Lenders, the ATI Notes Trustee and the Committee. The Plan proposes the following creditor recoveries: Class 1, Priority Non-Tax Claims, unimpaired; Class 2, Secured Claims, unimpaired; Class 3, Secured Lender Claims, unimpaired, Class 4, ATCW Unsecured Claims, impaired, with an estimated recovery of between 35.4% and 40.4% of each such allowed claim; Class 5, ATI Unsecured Claims, impaired with an estimated recovery of between 35.4% and 40.4% of each such allowed claim; Class 6, Subordinated Claims, impaired, with a recovery of 0% of allowed claims; and Class 7, Equity Interests, impaired, with a recovery of 0%.

53. The treatment under the Plan of allowed claims in Class 4 and Class 5 is the result of the Compromise and Settlement, as well as the deemed substantive consolidation of the ATCW Debtors for Plan purposes only. The substantive consolidation of the ATCW Debtors for plan purposes pools the assets and liabilities of each of the ATCW Debtors together, with the effect that a claim against any ATCW Debtor will be treated *pari passu* with any other claim

against an ATCW Debtor. The Compromise and Settlement resolves disputes between the ATI Notes Trustee, on the one hand, and the Debtors' remaining creditors, on the other hand, as to whether (i) Intercompanies allegedly payable to ATI, from the remaining Debtors, should be treated as debt or a capital contributions and (ii) the issuance of the liens and guarantees under the Prepetition Credit Agreement triggered the issuance of similar liens and guarantees to the Noteholders.

54. Under the Plan, the majority of the subsidiaries of ATCW are being reorganized and, as stated above, XO is purchasing the stock of these subsidiaries and substantially all of the assets of ATI and ATCW. Additionally, de minimis assets as well as the assets of four of ATCW's subsidiaries will be liquidated for the benefit of the Debtors' creditors. One subsidiary of ATCW, STFI, also will be restructured and the stock of reorganized STFI will be transferred to the ATLT for the benefit of those holders of allowed claims in Classes 4 and 5 that receive ATLT Interests under the Plan. The XO Common Stock also will be held by the ATLT for the benefit of the holders of Allowed Class 4 Claims and Allowed Class 5 Claims that receive ATLT Interests under the Plan.

ARGUMENT

I. THE PLAN HAS BEEN PROPOSED IN GOOD FAITH AND NOT BY ANY MEANS FORBIDDEN BY LAW

55. The Plan, which is the product of good faith, arm's length and arduous negotiations among (a) the Debtors, (b) the Committee, (c) the ATI Notes Trustee and (d) the Secured Lenders, satisfies each element of section 1129 of the Bankruptcy Code and should be confirmed. In fact, at confirmation, the Debtors will provide certification that creditors voting on the Plan have overwhelmingly approved the Plan and support its confirmation.

56. Among the parties objecting to confirmation of the Plan, is a group of the Debtors' and XO's competitors, consisting of MCI, Inc., KMC Telecom XI LLC and AboveNet, Inc. Collectively, these parties are referred to herein as the Dissenters.[9] The Dissenters challenge the confirmability of the Plan on the grounds that the Compromise and Settlement is not in the best interest of unsecured creditors and unfairly discriminates against creditors of the ATCW Debtors. The Dissenters base their challenge to the Plan on the assertion that the Compromise and Settlement is wholly unreasonable because:

- the ATI Notes Trustee's allegations of violations of the Indentures (the factual underpinnings of which have been extensively analyzed and verified by the Committee) does not provide a justification for the Compromise and Settlement;
- the Debtors cannot prove that there are valid Intercompanies supporting the Compromise and Settlement;
- the process that led to the Compromise and Settlement does not satisfy the appropriate legal standards; and
- the *pari passu* treatment of the claims of the Noteholders and the Dissenters is inappropriate because the Dissenters' claims are structurally senior to the Noteholders' claims.

See Trade Creditors' Objection to Confirmation of Debtors' Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code Dated April 22, 2004. Other than the objections of the Dissenters, no other major party in interest has interposed an objection to the Plan on similar grounds.

57. Although the Dissenters raise a panoply of concerns, stripped to the core, the principal issue presented by these Dissenters is whether the Plan, including the Compromise and Settlement and the proposed substantive consolidation (each of which will avoid extensive,

[9] SBC Telecommunications, Inc. and certain affiliates, BellSouth Telecommunications, Inc. and the telephone operating subsidiaries of Verizon Communications Inc also objected to the Plan, but the Debtors believe that these parties' objections to the Plan have been resolved.

protracted and costly litigation which would significantly and adversely effect all creditor recoveries) satisfies the good faith requirement of Bankruptcy Code section 1129(a)(3).

58. As discussed in more detail below, the Committee believes that the Plan meets the good faith requirements:

Honest Intentions

- The Debtors proposed the Plan with a legitimate and honest purpose to reorganize through the sale of substantially all of their assets to XO and the reorganization of STFI as a going concern. The Plan maximizes the value of the Debtors' assets, expedites emergence from chapter 11, has a reasonable prospect of success and at confirmation the Debtors will provide certification that the Plan has been accepted by all classes of creditors entitled to vote to accept or reject the Plan.

Compromise and Settlement

- The Compromise and Settlement, which forms the basis for the Plan is the only viable means of achieving a prompt reorganization of the Debtors' estates for the benefit of all creditors and these estates because:
  - The question of whether the Debtors violated the terms of the Indentures by borrowing under the Prepetition Credit Agreement and providing certain liens and guarantees in connection with such borrowing, without providing equal and ratable liens and guarantees to the Noteholders is complex, would require protracted litigation with unpredictable outcomes and would delay and reduce recoveries to creditors of the Debtors' estates;
  - Litigation over the recharacterization of the approximately $1.9 billion in Intercompanies owing from ATCW to ATI would raise factual issues for which there may be no answers and related litigation which would consume significant assets of the Debtors' estates and materially delay and reduce distributions to creditors; and
  - A delay in confirming the Plan caused by litigation over either of the foregoing components of the Compromise and Settlement would jeopardize the Debtors' sale of their assets to XO, to the detriment of all of the Debtors' creditors.

Substantive Consolidation

- Compelled by the facts of these cases, the Debtors determined to substantively

consolidate the ATCW Debtors in the Plan[10] because:

- trade creditors dealt with substantially all the Debtors as a single economic unit and did not rely on their separate identity in extending credit;
- the Debtors filed consolidated federal income tax returns and prepared financial statements, annual reports and other documents filed with the Securities and Exchange Commission on a consolidated basis;
- all financial information of the Debtors disseminated to the public, including to customers, suppliers, landlords, lenders and credit rating agencies, is prepared and presented on a consolidated basis;
- the Debtors share common directors and officers;
- the vast majority of the Subsidiaries exist solely to operate the ATCW business within individual state jurisdictions for regulatory purposes;
- the Debtors share overhead, management, accounting and other related expenses;
- ATCW pays the expenses and salaries of the Subsidiaries;
- all of the ATCW Debtors act from the same principal business location;
- the Debtors' cash is swept on a daily basis into a concentration account held by ATSC, a subsidiary controlled by ATCW;[11]
- Intercompanies have been recorded on a net basis (i.e., the system maintained a running balance that netted the Intercompanies between two given legal entities). As a result, it would be extremely difficult, time consuming and potentially impossible to unravel and research the numerous transactions embedded in particular intercompany accounts receivable and accounts payable balances;
- Intercompany transactions relating to periods prior to 1999 are recorded on a computerized legacy accounting system called Peachtree, which the Debtors no longer maintain and for which they no longer have relevant historical data files; and
- substantive consolidation benefits all creditors and does not unfairly prejudice any creditor group because, absent such consolidation, the Debtors would languish in chapter 11 while mired in massive litigation

[10] ATI is not a part of the substantive consolidation proposed in the Plan.

[11] For a detailed description of the Debtors' cash management system, see the Debtors' Motion for an Order Authorizing the Continued Use of Existing Cash Management System, filed May 14, 2003.

over the Intercompanies and potentially jeopardize the value maximizing sale of the Debtors' assets to XO.

59. In summary, the Compromise and Settlement and the substantive consolidation proposed in the Plan provide unsecured creditors with a fair and equitable recovery from these estates because (i) the Compromise and Settlement preserves significant value for the Debtors' unsecured creditors and avoids protracted litigation which could jeopardize creditor recoveries and the sale of the Debtors' assets to XO and (ii) there is no way to establish the true assets and liabilities of any one of the Subsidiaries without figuring out each ATCW Debtors' assets and liabilities, including the value of each Intercompany.

60. Section 1129(a)(3) of the Bankruptcy Code requires that a plan be "proposed in good faith and not by any means forbidden by law." 11 U.S.C. § 1129(a)(3). The Second Circuit defines the good faith standard as requiring a showing that "the plan was proposed with 'honesty and good intentions.'" Kane v. Johns- Manville Corp., 843 F.2d 636, 649 (2d Cir. 1988). In the context of a chapter 11 plan, "a plan is proposed in 'good faith' 'if there is a likelihood that the plan will achieve a result consistent with the standards prescribed under the Code.'" In re Leslie Fay Cos., Inc., 207 B.R. 764, 781 (Bankr. S.D.N.Y. 1997) (quoting In re Texaco Inc., 84 B.R. 893, 907 (Bankr. S.D.N.Y.), appeal dism'd, 92 B.R. 38 (S.D.N.Y. 1988)); see also In re Zenith Elecs. Corp., 241 B.R. 92, 107 (Bankr. D. Del. 1999). The good faith standard applies to chapter 11 plans of liquidation as well as plans of reorganization. See, e.g., In re River Vill. Assocs., 161 B.R. 127, 140 (Bankr. E.D. Pa. 1993) aff'd, 181 B.R. 795 (E.D. Pa. 1995); In re Jandous Elec. Constr. Corp., 115 B.R. 46 (Bankr. S.D.N.Y. 1990); In re Gillette Assocs., Ltd., 101 B.R. 866, 873 (Bankr. N.D. Ohio 1989).

61. The Plan accomplishes these goals by providing the only means through which the Debtors may effectively emerge from chapter 11 while maximizing value for creditors.

Moreover, the support of the Plan by the Committee, the ATI Notes Trustee and the Secured Lenders reflects the collective acknowledgment by the Debtors' major creditor constituencies that the Plan provides fundamental fairness and the greatest possible recovery to all unsecured creditors. Inasmuch as the Plan promotes the objectives and purposes of the Bankruptcy Code, the Plan should be confirmed.

II. THE COMPROMISE AND SETTLEMENT EMBODIED IN THE PLAN SHOULD BE APPROVED

62. Incorporated in the Plan is the Compromise and Settlement of prospective litigation over alleged violations of the Indentures and the Prepetition Credit Agreement as well as prospective litigation over the treatment of certain Intercompanies owing from the ATCW Debtors to ATI. Given the potential for complex, protracted and expensive litigation over these issues, the Debtors, the Committee, the ATI Notes Trustee and the Secured Lenders agreed to the Compromise and Settlement. The proposed Compromise and Settlement provides, among other things, that Holders of Allowed Claims in Classes 4 and 5 receive *pari passu* recoveries of between 35.4% and 40.4% in consideration for their claims and the strengths and weaknesses of potential litigation arguments made by each of the Debtors, the Committee and the ATI Notes Trustee.[12] In the absence of the Compromise and Settlement, there can be no guarantee as to what recoveries unsecured creditors would obtain in these cases.

63. Courts, as a general rule, favor compromises, as compromises are "a normal part of the process of reorganization." Barry v. Smith (In re New York, N.H. & H.R. Co.), 632 F.2d 955, 959 (2d Cir.), cert. denied sub nom., Barry v. American Fin. Enters. Inc., 449 U.S. 1062, 101 S. Ct. 786 (1980) (citing Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 130, 60 S.

[12] Pursuant to the Compromise and Settlement, the Secured Lenders agreed to waive claims to default interest and up to $26 million in cash.

Ct. 1, 14 (1939)); see In re Best Prods. Co., 168 B.R. 35, 44 (Bankr. S.D.N.Y. 1994), appeal dism'd, 177 B.R. 791 (S.D.N.Y.), aff'd, 68 F.3d 26 (2d Cir. 1995). A debtor entering into compromises and settlements with respect to complicated factual and legal disputes comports with the general public policy favoring settlements. See Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424, 88 S. Ct. 1157, 1163 (1968) (citing Case, 308 U.S. at 130); In re Hibbard Brown & Co., 217 B.R. 41, 46 (Bankr. S.D.N.Y. 1998).

64. Pursuant to Bankruptcy Rule 9019 "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." Fed. R. Bankr. P. 9019. The bankruptcy court may exercise its discretion and make an independent determination of whether to approve a settlement under Bankruptcy Rule 9019. See Nellis v. Shugrue, 165 B.R. 115, 123-124 (S.D.N.Y. 1994); see Hibbard Brown, 217 B.R. at 46.

65. A settlement may be approved by a bankruptcy court where it is "supported by adequate consideration, is 'fair and equitable,' and is in the best interest of the estate." Air Line Pilots Assoc., Int'l v. American Nat'l Bank & Trust Co. (In re Ionosphere Clubs, Inc.), 156 B.R. 414, 426 (S.D.N.Y. 1993), aff'd, 17 F.3d 600 (2d Cir. 1994); see also TMT Trailer Ferry, 390 U.S. at 424, 88 S. Ct. at 1163. The bankruptcy court is not required to determine the questions of law and fact raised by the issues to be settled but, rather, to determine whether the settlement "fall[s] below the lowest point in the range of reasonableness." In re W.T. Grant Co., 699 F.2d 599, 608 (2d Cir.), cert denied, 464 U.S. 822, 104 S. Ct. 89 (1983) (citing Newman v. Stein, 464 F.2d 689, 693 (2d Cir.), cert denied, 409 U.S. 1039, 93 S. Ct. 521 (1972)). To determine whether the proposed settlement satisfies the "lowest range of reasonableness" test, courts consider the following factors:

(a) the probability of success in the litigation;

(b) the difficulties associated with collection;

(c) the complexity of the litigation, and the attendant expense, inconvenience, and delay; and

(d) the paramount interests of the creditors.

See In re Drexel Burnham Lambert Group, Inc., 960 F.2d 285, 292 (2d Cir. 1992), cert. dism'd, 506 U.S. 1088, 113 S. Ct. 1070 (1993); In re Ionosphere Clubs, 156 B.R. at 428; In re Best Prods. Co., 168 B.R. at 44-45. These standards "reflect the considered judgment that little would be saved by the settlement process if bankruptcy courts could approve settlements only after an exhaustive investigation and determination of the underlying claims." See In re Best Prods. Co., Inc., 168 B.R. at 51 (citing In re Purofied Down Prods. Corp., 150 B.R. 519, 522-23 (S.D.N.Y. 1993)). Among other factors, when exercising this discretion, the bankruptcy court may consider the experience and competency of counsel supporting the settlement. Nellis, 165 B.R. at 124; In re Ionosphere Clubs, Inc., 156 B.R. at 426; In re Purofied Down Prods. Corp., 150 B.R. at 521.

66. Courts have found that settlements benefit creditors and should be approved when, among other things: (i) claimants settle for less than the value of their claims, (ii) the settlement allows a debtor to proceed to confirmation without the obstacle of litigation in its path, and (iii) litigation would be detrimental to the debtor and its creditors due to the expense and time such litigation would require. See O'Cheskey v. United States, No. 3-00-CV-0142-P, 2001 U.S. Dist. LEXIS 21370, at *10 (N.D. Tex. Dec. 21, 2001) ("[T]he bankruptcy court found that the settling parties conferred value on the estates by settling for amounts that likely were less than the value of their claims."); In re Allegheny Int'l, Inc., 118 B.R. 282, 309 (Bankr. W.D. Pa. 1990) (finding that benefits of settlement included, among other things, (i) the elimination of substantial expenses to the estate that otherwise would be incurred if the litigation continued

through trial and subsequent appeal; (ii) the elimination of the risk of a verdict unfavorable to plaintiffs if the litigation should proceed to trial; (iii) the ability to proceed with the reorganization without the risk of delay arising from the litigation; and (iv) the significant monetary concessions by the parties on their claims; In re Texaco Inc., 84 B.R. at 902-03 (noting that shareholders would receive no recovery if Pennzoil was paid its claim in full and, therefore, settlement was fair and equitable, benefiting creditors, because Pennzoil received less than its full claim, allowing shareholders some recovery).

67. The premise of the Compromise and Settlement is the resolution of complex legal and factual issues. By effecting the Compromise and Settlement, the Debtors and their creditors removed specific obstacles to confirmation of the Plan, thereby allowing for the Debtors' exit from chapter 11, which benefits all creditors. Due to the complexity of the issues settled, as discussed below: (a) it is not possible to determine with any certainty the likelihood of success in litigating these issues; and (b) litigating the issues would (i) delay the Debtors' emergence from chapter 11 thereby resulting in an attendant erosion of significant value of the Debtors' estates, (ii) delay distributions to creditors, (iii) add innumerable costs to the Debtors' estates to the detriment of all creditors and (iv) jeopardize the closing of the Sale as contemplated by the Plan and the Purchase Agreement. The Compromise and Settlement was thoroughly negotiated and reviewed by the Debtors, the Committee, the ATI Notes Trustee and the Secured Lenders and has the support of the classes of creditors entitled to vote on the Plan. Accordingly, the Compromise and Settlement falls within the range of reasonableness and should be approved.

68. The Compromise and Settlement provides for the treatment afforded to the holders of allowed unsecured claims of ATI and the ATCW Debtors, respectively. The Debtors, the Committee, the Secured Lenders and the ATI Notes Trustee agreed that under the

Compromise and Settlement, the Noteholders and other unsecured creditors at ATI will receive a percentage recovery on their claims equal to the percentage recoveries to be received by unsecured creditors at ATCW notwithstanding the alleged structural seniority of the claims held by creditors of the ATCW Debtors.

69. Embodied in Compromise and Settlement is the resolution with the ATI Notes Trustee of numerous litigable and complex legal and factual issues including:

- whether there were violations of negative pledge covenants in the Indentures in connection with the granting of certain liens and guaranties to the Secured Lenders under the Prepetition Credit Agreement;
- whether as a result of such alleged violations of the Indenture, the Noteholders were entitled liens on assets of the Debtors;
- whether as a result of such alleged violations of the Indentures, the Noteholders were entitled to equal and ratable guarantees from each of the ATCW Debtors; and
- the allowance or disallowance of intercompany claims and the corresponding litigation related thereto.

A. The Debtors' Probability of Success in Litigating the Settlement Issues is Unclear

70. The litigated outcome of the Settlement Issues requires an intense factual and legal analysis and is uncertain.

71. Disputes Regarding Violation of Negative Pledge Covenants in the Indentures. The ATI Notes Trustee alleges that the Debtors violated covenants in the Indentures prohibiting the Debtors' grant of liens and/or guaranties absent the grant of equal and ratable liens and guaranties to the ATI Notes Trustee for the benefit of the Noteholders when the Debtors granted liens and guaranties to the Secured Lenders pursuant to the Prepetition Credit Agreement. As a result of the alleged violations, the ATI Notes Trustee has asserted that the Noteholders are entitled to (i) guaranty claims against all of the Debtors and (ii) equal and ratable liens on all of

the assets of all of the Debtors. These assertions were disputed by the Debtors and the Secured Lenders and have been settled in connection with the Compromise and Settlement.

72. In addition, the Committee separately investigated the validity of the Secured Lenders' prepetition liens and guarantees and the ATI Notes Trustee's allegations. The Committee independently concluded that if there were violations of the Indentures in connection with the granting of the liens and guarantees to the Secured Lenders and, absent the Compromise and Settlement, there existed a colorable claim to subordinate all or portions of the Secured Lenders' claims for the benefit of unsecured creditors based on allegations of wrong doing on the part of the Secured Lenders in connection with the violations of the Indenture.

73. Rather than controvert the fact that the violations of the Indentures asserted by the ATI Notes Trustee would have been litigated with the Debtors and the Secured Lenders in the absence of the Compromise and Settlement, the Dissenters reassert positions and issues raised by the Debtors in connection with the underlying negotiations of the Compromise and Settlement.

74. First, the Dissenters rely upon the Debtors' assertion that the Debtors "carefully tracked [their] use of funds to demonstrate [the use of funds covenant in the Credit Agreement, which mirrored that in the bond indentures] and indenture covenants" to assert that the alleged Indenture violations are fabricated. Dissenters' Brief at 12 (citing Tresnowski Covenant Analysis at 2). As discussed above, however, the ATI Notes Trustee has asserted that (a) ATCW borrowed, in September 2001 and July 2002, an aggregate of $485.3 million under the Prepetition Credit Agreement, and subsequently repaid $20 million, (b) at least $216.8 million of the $270 million of the Debtors' cash on hand as of June 2003 constituted borrowings under the Prepetition Credit Agreement, (c) since September 2001, total Capital Expenditures have been $248.5 million and anticipated Capital Expenditures in the future are expected to be

approximately $50 million per annum, (d) thus, at least $116 million of the funds the Debtors borrowed in July 2002 were not incurred to finance Capital Expenditures, and (e) accordingly, the incurrence of such debt and the liens and guarantees granted in respect thereto, violated the Indentures and the Prepetition Credit Agreement.

75. Second, the Dissenters argue that the Debtors, themselves, have concluded in past studies, and elsewhere, that there were no violations of the Indentures created by the Debtors' entry into the Prepetition Credit Agreement. The ATI Notes Trustee, however, concluded the opposite – that the liens and guarantees granted with respect to the Prepetition Credit Agreement violated the terms of the Indentures. Further, the ATI Notes Trustee concluded that these violations entitled the Noteholders to guarantees from the Debtors and equal and ratable liens against the Debtors in respect of the Notes issued under the Indentures. Moreover, in the very memorandum cited by the Dissenters, Mark Tresnowski acknowledges that a valid guarantee on the Notes likely would exist from each of the Debtors' operating subsidiaries. Tresnowski Covenant Analysis at 3

76. The only thing the Dissenters have established through their long winded objection and related assertions is that there is a *bona fide* dispute as to whether the Debtors violated the Indentures and the remedies available to the Noteholders in respect of such violations. The fact that the Dissenters question whether there were violations of the Indentures and disagree with the assertions of the ATI Notes Trustee and the factual analysis conducted by the Committee is evidence that the parties were well advised to enter into the Compromise and Settlement and preserve millions of dollars for the benefits of the estates' creditors in the process.

77. Dispute Concerning Equal and Ratable Liens. There is a litigable issue concerning the remedy available to the ATI Notes Trustee in the event the Indentures were violated. The ATI Notes Trustee asserts that such violations entitle the Noteholders to equal and ratable liens against assets of the ATCW Debtors. Courts have awarded equitable liens when the negative pledge at issue is not purely negative but, similar to the negative pledge covenant at issue in the Indentures, is an affirmative negative pledge covenant.[13] See, e.g., Chase Nat'l Bank of New York v. Sweezy, 281 N.Y.S. 487, 491 (Sup. Ct. N.Y. County 1931) (holding that a bank that had notice of a negative covenant in indenture was bound by such covenant, and debenture holders should share equally with the bank because an equitable lien was created); Kaplan v. Chase Nat'l Bank of New York, 156 Misc. 471, 472, 281 N.Y.S. 825, 826 (Sup. Ct. N.Y. County 1934) (holding that covenant in indenture that corporation would not "suffer to exist any lien or pledge upon the stock of its subsidiaries without making ratable provision for the securing of the bonds in question" was violated upon corporation's granting of liens to subsequent lenders and, therefore, debenture holders should share ratably with defendant); Connecticut Co. v. New York, N.H. & H.R. Co., 94 Conn. 13, 107 A. 646, 652 (Conn. 1919) (finding that covenant in bonds providing affirmatively that equal and ratable lien would be provided if property at issue was mortgaged resulted in equitable liens for bondholders); In re Associated Gas & Elec. Co., 61 F. Supp. 11 (S.D.N.Y. 1944), aff'd on other grounds, 149 F.2d 996 (2d Cir.), cert. denied, 326 U.S. 736, 66 S. Ct. 45 (1945). Consequently, the ATI Notes Trustee asserts that the ATI Note Claims are secured claims against, and equally and ratably guaranteed by, each of the Debtors.

[13] Affirmative negative pledge covenants prohibit encumbrances, but also: (i) affirmatively covenant that if the borrower gives security for a loan from a third party, then the borrower will equally and ratably secure the negative pledgee; or (ii) provide that, notwithstanding the covenant's general prohibition on encumbrances, an encumbrance is permitted if, by its own terms, it gives equal and ratable security to the negative pledgee. See Carl S. Bjerre, Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection, 84 Cornell L. Rev. 305, 319 (1999).

78. There are contrary arguments. The Dissenters dispute the ATI Notes Trustee's allegations and interpretation of the law (a position initially advanced by the Debtors and Secured Lenders), establishing that the issue was disputed by major parties in interest, and thus the appropriateness of the Compromise and Settlement. The Dissenters assert that in order to create a security interest, the Indentures must establish an affirmative intention to create a lien. Hassett v. Revlon, Inc. (In re O.P.M. Leasing Servs., Inc.), 23 B.R. 104, 119 (Bankr. S.D.N.Y. 1982); see also Bank of New York v. Epic Resorts--Palm Springs Marquis Villas, LLC (In re Epic Cap. Corp.), 290 BR. 514 (Bankr. D. Del. 2003), aff'd, 307 B.R. 767 (D. Del. 2004)[14];

[14] Although the Dissenters may now cite cases such as Epic Capital for the proposition that a court would not award an equitable lien to the Noteholders or equitably subordinate the Secured Lenders' liens, the Epic decision is inapposite. While the indenture trustee in Epic, as here, asserted that a lien subsequently provided to the debtors' lenders was granted improperly, in derogation of the noteholders' security interests under an indenture, the following dispositive differences, among others, distinguish the Epic case from the instant case. First, Epic was governed by federal, not state law, because the encumbered property was Indian land, governed by specific federal law. The trustee's assertion that the noteholders held a security interest in the property was overruled by the court because federal law required that there could be no interest in Indian lands unless the security interest was specifically approved by both the Secretary of the Interior and the Bureau of Indian Affairs. Thus, regardless of perfection, avoidability or other defenses to the noteholders' liens, there was no question but that the noteholders held no valid lien in the debtors' property. Second, the provisions of the indenture did not involve an affirmative negative pledge covenant, but rather only a provision that the parties to the indenture would use their "reasonable best efforts" to gain the required approvals to grant the noteholders a lien, but contained no language indicating an intention to actually grant a security interest upon closing (the opposite of the Indentures at issue here). Third, the court held that although the indenture prohibited the granting of additional liens on the property at issue, because the noteholders never had a security interest in the property in the first place, the noteholders were not prejudiced by the subsequent grant of a security interest in the property to the lenders.

Hechinger Liq. Trust v. BankBoston Retail Fin., Inc. (In re Hechinger Inv. Co. of Del., Inc.), Civ. No. 00-973-SLR, 2004 WL 724960, at *4 (D. Del. March 28, 2004).[15] Accordingly, the Dissenters maintain that the applicable provisions as well as the circumstances attendant to the negotiation of the Indentures, do not "clearly establish the intention that the premises [to be secured] would be held, given or transferred as security for the obligation of the contract." See Pennsylvania Oil Prods. Ref. Co. v. Willrock Produc. Co., 267 N.Y. 427, 435, 196 N.E. 385 (1935); Cherno v. Dutch Am. Mercantile Corp. (In re Itemlab, Inc.), 353 F.2d 147, 153 (2d Cir. 1965). They also argue that the provision is merely "[a]n agreement . . . not to do certain things in respect thereto" and cannot be construed as affirmatively giving the Noteholders any interest in the Debtors' property. See Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497, 507 (D.C. N.Y. 1935), rev'd & remanded on other grounds, 85 F.2d 61 (2d Cir. 1936).

79. Based on the foregoing differing legal precedent, the outcome of this dispute cannot be predicted with any certainty.

80. Dispute Over Perfection of Lien Claims. Opponents of the ATI Notes Trustee's assertions with respect to the equitable liens argue that even if an equitable lien is otherwise appropriate, the Noteholders must have perfected their liens in order to enforce them and that such an unperfected lien may be avoidable under section 544 of the Bankruptcy Code. However,

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[15] Although Hechinger was decided after the Compromise and Settlement was agreed to by all parties in interest in these cases and thus could not have been considered by them, it is also distinct from the situation at bar. Hechinger involved a number of issues analogous to the issues addressed by the Compromise and Settlement (the assertion by noteholders that a subsequent grant of security to the lenders under a credit agreement, without the provision of equal and ratable security interests to the noteholders, violated an affirmative negative pledge covenant in the noteholders' indentures), one of the primary issues was the uncertainty, as a factual matter, as to whether the subsequent security interest actually violated the negative pledge covenant. In Hechinger, the Court held that the plaintiff has the burden of demonstrating both the breach of the negative pledge and knowledge by the defendants of both the negative pledge clause and its breach. The court determined that the lenders were under no legal duty to know of the fact that may have resulted in a violation of the negative pledge. In these cases, the Committee believes that colorable claims exist with respect to the alleged violations of the negative pledge and that the offending parties had knowledge of such clauses and alleged violations. Thereby, subjecting the offending party to a sharing of its liens.

there is the prospective applicability of certain exceptions to the general requirement of affirmative perfection. An equitable lien may not require perfection to be enforceable. For example, under New York law, an equitable lien may be awarded pursuant to the "contractual exception" where, "it is clear from a contract that the purpose and intent of the parties was to give a lien . . . upon specific property." Bank of India v. Weg & Myers, 257 A.D.2d 183, 192, 691 N.Y.S. 2d 439, 445 (1st Dep't 1999) (internal citations omitted); see Cherno, 353 F.2d at 153 (same); Rosario-Paolo, Inc. v. C&M Pizza Restaurant, Inc., 84 N.Y.2d 379, 643 N.E.2d 85 (1994) (finding that breach of covenant to name vendor as beneficiary of insurance policy resulted in imposition of equitable lien against insurer with notice who wrongfully paid insurance proceeds to third party); Carl S. Bjerre, Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection, 84 Cornell L. Rev. 305, 319 (1999) ("A court imposes an equitable lien when the parties, though intending to create a security interest, have failed to comply with the statutory formalities necessary to do so."); General Ins. Co. v. Lowry, 412 F. Supp. 12, 14 (D.S. Ohio 1976) (citing Aetna Cas. & Sur. Co. v. Brunken & Son, Inc., 357 F. Supp. 290 (D.S.D. 1973)) ("[a]lthough courts should hesitate to invoke equity powers to disturb the operation of a statute, nothing in the Uniform Commercial Code precludes the imposition of an equitable lien in narrowly-circumscribed situations."). Thus, even an avoidance action commenced under section 544 of the Bankruptcy Code would not necessarily trump an unperfected equitable lien under New York law. But see In re Allegheny Int'l., Inc., 93 B.R. 907, 910 (Bankr. W.D. Pa. 1988) (unperfected equitable liens are avoidable by a debtor under section 544 of the Bankruptcy Code). Accordingly, the outcome of litigation related to the perfection of an equitable lien is unclear.

81. Dispute Concerning Equal and Ratable Guarantees. The ATI Notes Trustee has asserted, and the Dissenters do not deny, that the provision of guarantees by the Subsidiaries under the Prepetition Credit Agreement, triggered the Subsidiaries' obligation to provide equal and ratable guarantees to the Noteholders under the Indentures. As cited above, section 4.07 of the Indentures provides that:

> [ATI] will not permit any Restricted Subsidiary, directly or indirectly, to Guarantee any Indebtedness of [ATI] which is pari passu with or subordinate in right of payment to the Notes ("Guaranteed Indebtedness"), unless (i) such Restricted Subsidiary simultaneously executes and delivers a supplemental indenture to this Indenture providing for a Guarantee (a "Subsidiary Guarantee") of payment of the Notes by such Restricted Subsidiary…

Indentures, § 4.07.

82. Simply stated, and uncontroverted by the Dissenters, is the argument that the failure of a party to honor an agreement to provide a guarantee gives rise to a breach of contract claim along with an unsecured claim against the party that was to have provided a guarantee. See e.g., Hawley Fuel Coalmart, Inc. v. Steag Handel, 796 F.2d 29 (2d Cir. 1986), cert. denied, 479 U.S. 1066, 107 S. Ct. 954 (1987) (finding that a breach of either a guarantee or an agreement to provide a guarantee, supported parties' breach of contract claim); Carl v. Galuska, 785 F.Supp. 1283 (N.D.Ill. 1992) (same); In re Manzey Land & Cattle Co., 17 B.R. 332 (Bankr. D. S.D. 1982) (undersecured claim against one debtor in bankruptcy proceeding, guaranteed by another debtor in same proceeding, gave rise to an unsecured claim against the other debtor); see also Bruce Energy Ctr. Ltd. v. Orfa Corp. (In re Orfa Corp.), 129 B.R. 404 (Bankr. E.D. Pa. 1991) (creditor had unsecured claim against guarantor arising from guarantor's guarantee of payment of underlying debt). Accordingly, absent the Compromise and Settlement, the ATI Notes Trustee would advance a colorable claim that the Noteholders should be entitled to unsecured claims against each of the Debtors in respect of the guarantees that the Debtors were

required to provide under section 4.07 of the Indentures. Such a claim, if allowed, would share *pari passu* with the claims of all other unsecured creditors, including those of the Dissenters.

83. Though the Dissenters have scarcely addressed the guarantee issue, the Debtors, the Committee and the ATI Notes Trustee determined that it would be appropriate to enter into the Compromise and Settlement because of the potential for litigation concerning unsecured claims related to the guarantees. Litigation over such claims would undoubtedly involve protracted litigation into whether a violation of section 4.07 of the Indenture occurred. While defenses may be available to the ATI Notes Trustee's assertions based on the lack of privity of contract between the ATCW Debtors and the ATI Notes Trustee, the ATI Notes Trustee could logically assert that ATI, as the ATCW Debtors' parent company, had authority to make commitments regarding the negative pledge covenants on behalf of the ATCW Debtors and that, in any event, the ATCW Debtors were complicit in the violation because they were all controlled by the same officers, directors and management as ATI. The outcome of this dispute likewise cannot be determined with any certainty.

84. In short, the litigation over the violation of the negative pledge covenants would be complex, involve protracted discovery, would be exceedingly expensive for the estates and their creditors and could involve a variety of outcomes. The Court could find that the Noteholders were entitled to guarantees from each of the Debtors and thus that they hold unsecured claims against all of the Debtors warranting *pari passu* treatment. Alternatively, the Court could find that the Noteholders have both valid liens and guarantees or, possibly, neither. Finally, the Noteholders also could pursue a variety of additional related claims, including (i) proceeding against the Secured Lenders to have the loans and pledges set aside, if the Secured

Lenders had notice of the negative pledge covenant,[16] or (ii) initiating claims for tortious interference with contract against the ATCW Debtors and the Secured Lenders.[17]

85. The Dissenters simply ignore the reality that protracted litigation over these issues would cost these estates millions of dollars in litigation expenses plus additional fees and could threaten the Sale, which is the very underpinning of most of the creditor recoveries provided for under the Plan. See Tresnowski Dep. at 240:17-21 ("The down side to me is much more drastic than that. The down side to me is not settling the claims, litigating the claims, losing the XO deal, having the banks impaired, having the trade creditors get nothing.") (emphasis added). Because of this threat of litigation and the immense potential consequences to these cases, the Debtors, the Committee and other parties in interest entered into and support the proposed the Compromise and Settlement with respect to the negative pledge covenant claims.

86. Disputes Related to Intercompanies Between ATI and ATCW. Serious litigable issues also exist with respect to an Intercompany flowing from the ATCW Debtors to ATI. The Debtors' books and records reflect a $1.9 billion debt owing from ATI to ATCW. Applicable precedent, as well as an array of conflicting evidence render unclear the question of whether the advance underlying these Intercompanies should be characterized as (a) capital contributions from ATI to the ATCW Debtors or (b) debt obligations from the ATCW Debtors to ATI.

87. If protracted litigation ensued with respect to the characterization of the $1.9 billion debt from ATCW to ATI and this Court determined that the transactions underlying such Intercompanies were in the nature of capital contributions, the Noteholders would not receive the

[16] See Kelly v. Central Hanover Bank & Trust Co., 85 F.2d 61 (2d Cir. 1936) (suggesting that debenture holders could set aside loans if lending bank had knowledge of violation of covenant in indenture).

[17] See First Wyoming Bank v. Mudge, 748 P.2d 713, 717 (Wyo. 1988) (the knowing violation of a negative pledge covenant gives rise to cause of action for tortious interference with contract)

benefit of amounts collected by or otherwise due ATI by its subsidiary. However, if the Court characterized the aforementioned transactions as loans and determined that the full amount of such Intercompanies constituted allowed claims, the distributions to ATI on account of its claims would drastically reduce the distributions made to holders of allowed claims against ATCW and the Subsidiaries.

88. Courts rely on section 105(a) of the Bankruptcy Code, which provides bankruptcy courts with general equitable powers to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title" for authority to recharacterize claims. 11 U.S.C. §105(a); see Ali Inc. v. Cold Harbor Assocs. (In re Cold Harbor Assocs.), 204 B.R. 904, 915 (Bankr. E.D. Va. 1997). Courts in the Second Circuit have recognized recharacterization as an available remedy, In re Interstate Cigar Co., 182 B.R. 675, 678 (Bankr. E.D.N.Y. 1995), aff'd, 166 F.3d 1200 (2d Cir. 1998), although some courts do not. See In re Pacific Express, Inc., 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986).

89. In determining whether to recharacterize a claim, bankruptcy courts are required to "weigh[] the substance over the form of the advance." In re Interstate Cigar Co., 182 B.R. at 678 (citations omitted). While no one factor is decisive, generally, courts consider, among others, the following factors in assessing whether to recharacterize a claim:

- names given to documents evidencing indebtedness;
- presence or absence of a fixed maturity date and schedule of payments;
- presence or absence of a fixed rate of interest and interest payments;
- source of repayments;
- identity of interest between the creditor and the stockholder;
- corporation's ability to obtain financing from outside lending institutions;

- extent to which the advances were subordinated to the claims of outside creditors; and
- the intent of the parties.

90. Upon reviewing the facts and legal issues surrounding recharacterization of the Intercompanies running from the ATCW Debtors to ATI, arguments both in favor and against recharacterization exist. For example, the identity of interest between the creditor and stockholder, the failure to reliably specify an applicable interest rate or maturity date for the repayment of certain advances and the incomplete documentation of the loans support a determination that the Intercompanies are capital contributions. On the other hand, the intent of the parties to establish intercompany loans, and the recording of intercompany advances as loans in the Debtors' books and records,[18] weigh in favor of treating the advances as valid debt obligations.

91. The Dissenters assert that the provisions regarding the holding company structure of the Debtors support the contention that the Notes are subordinate:

> [t]he 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.

Allegiance Telecom, Inc. Form S-4 Registration Statement Under the Securities Act of 1933, dated March 31, 1998, at 19 (emphasis added).

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[18] See Tresnowski Dep. at 181:24-25-182:2 ("[O]ur accounting records reflect a claim of approximately $1.9 billion that ATI has against ATCW"); Breeden v. Bennett (In re Bennett Funding Group), 220 B.R. 743, 768 (Bankr. N.D.N.Y. 1997) ("[E]ntry of an advance on corporate books is sufficient to evidence an intercompany loan"); United States v. Fidelity Capital Corp., 920 F.2d 827, 838 (11th Cir. 1991) ("An entry on the corporate books is a sufficient formality, under Georgia law, [to characterize obligations as] an intercorporate loan.").

92. The highlighted provision above, that ATI "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***" would, however, be cited by the ATI Notes Trustee for the proposition that there was a publicly stated intention to repay advances made from the proceeds of the Notes, not only with dividends from the ATCW Debtors, but also with "other payments", i.e. intercompany payments from the ATCW Debtors to ATI. See Tresnowski Dep. at 224:13-17 ("[A]s I read this, if you contribute equity capital, okay, not a loan but equity, the only way you can get money back would be a dividend. And so when it says 'other payments,' that would include a loan payment.").

93. These differing interpretations underscore the premise that recharacterization of the Intercompanies is a highly litigable issue, and the outcome of such litigation is uncertain. As with the lien and guarantee issues, settlement of this issue is justified by avoiding litigation and preserving the benefit of the Sale for all creditors. See Tresnowski Dep. at 240:3-11 ("I'd have to set aside more than just the possibility they [XO] wouldn't close [as the downside to litigating the recharacterization issues]. Unfortunately, they [XO] have been very litigious about all kinds of issues … And setting aside that even if they do close, if we're in bankruptcy for a long period of time, there's going to be more cash used to pay debt [and] service on the senior debt paid professionals…").[19]

[19] The Dissenters assert that the claims of the Noteholders are structurally subordinate to the claims against the ATCW Debtors and, therefore, such claims cannot be satisfied prior to the payment in full of the claims against the ATCW Debtors. This asserted basis for objection, however, is nothing more than a red herring as the issues being resolved by the Compromise and Settlement moot this objection.

B. Absent the Settlement, Litigation of the Settlement Issues Would be Complex and Costly, Delay the Debtors' Emergence from Chapter 11 and Result in an Attendant Erosion of Significant Value

94. Litigation of the issues resolved by the Compromise and Settlement would be costly and delay the Debtors' emergence from chapter 11 as well as distributions to creditors, to the detriment of all creditors. Litigation of the negative pledge issues likely would involve extensive discovery into the intent of the parties to the Indentures, extensive legal briefing as to the competing legal theories discussed above and extensive motion practice, presumably including motions to dismiss and for summary judgment. Likewise, litigation with respect to the recharacterization dispute would include protracted discovery into the documentation supporting each Intercompany and the Debtors' ability to reconcile historical financial intercompany obligations. Litigation of the recharacterization issues would be particularly complicated by the absence of accurate financial records, the inability to access the Debtors' legacy accounting systems and the lack of employees knowledgeable about the Debtors' prepetition financial affairs. Moreover, given the ongoing litigation concerning the Purchase Agreement between XO and the Debtors, it is also possible that a delay of Plan confirmation could threaten the Sale in its entirety, forestall any possible settlement of such litigation, to the detriment of all of the estates' creditors.

C. The Settlement Is in the Best Interest of Creditors

95. As discussed above, the Court need only determine whether a proposed settlement falls below the lowest point in the range of reasonableness in approving such settlement. In evaluating the Settlement Issues discussed above, the Committee evaluated the following potential litigation outcomes, among others, based on data available to the Committee at the time, to determine if the settlement was in the best interests of creditors:

- If all trade claims, rejection damages claims and capital lease deficiency claims were treated as structurally senior to the Notes and the transactions underlying the Intercompanies were treated as capital contributions, such Intercompanies would be in the nature of equity interests, and, thus, (a) the Noteholders would receive only the residual value of the ATCW Debtors' assets, for a total recovery of between 38.2% and 55.7%, while (b) general unsecured creditors would be paid in full.

- If the Noteholders prevailed in their litigation, resulting in the Noteholders receiving a secured claim equal to $116.8 million, and the Noteholders' deficiency claims were treated as *pari passu* with trade claims, rejection damages claims and capital lease deficiency claims, and all Intercompanies were cancelled, (i) Noteholders would receive between 45.1% and 59.2% of their allowed claims while (ii) general unsecured creditors would receive between 33.6% and 50.7% of their allowed claims.

- If the trade claims, rejection damages claims and capital lease deficiency claims were treated as structurally senior to the Notes, and assuming the $1.9 billion of Intercompanies owing from the ATCW Debtors to ATI were valid, (a) the Noteholders would receive between 46.8% and 61.2% of their allowed claims and (b) the general unsecured creditors would receive between 16.6% and 21.7 % of their allowed claims.

- In the event that the Noteholders prevailed in their litigation, the Noteholders would receive a pro rata secured claim of $116.8 million, and assuming the $1.9 billion of Intercompanies owing from the ATCW Debtors to ATI were valid and all trade claims, rejection damages claims and capital lease deficiency claims were treated as structurally senior to the Notes, (a) the Noteholders would receive between 47.4% and 61.2% of their allowed claims and (b) general unsecured creditors would receive between 10.7% and 15.7% of their allowed claims.

- If all unsecured creditors were treated *pari passu* and Intercompanies were cancelled, (a) the Noteholders would receive between 44% and 58.6% of their allowed claims and (b) general unsecured creditors would receive between 44% and 58.6% of their allowed claims.

96. As evidenced by the foregoing discussion, the Compromise and Settlement essentially splits the difference between the foregoing recovery scenarios by treating all unsecured creditors on a *pari passu* basis and canceling the Intercompanies, and, as a result, proposes recoveries between 35.4% and 40.4% for the Noteholders as well as the Debtors' unsecured creditors. Accordingly, the Compromise and Settlement falls within the applicable range of reasonableness and should be approved because: (i) the Debtors' probability of successfully litigating the Settlement Issues is unclear; (ii) litigation of the Settlement Issues

would be complex, and add tremendous expense and inconvenience to these cases, delaying the Debtors' emergence from chapter 11 and distributions to creditors; and (iii) the Compromise and Settlement is in the best interest of creditors.

97. The Committee, after conducting its own exhaustive diligence and review of the Settlement Issues, determined that the Compromise and Settlement is in the best interest of creditors because:

(a) recharacterization of the Intercompanies will not have to be litigated;

(b) the Debtors' estates and creditors will not suffer the time, expense and delay that would otherwise result from litigating the Settlement Issues;

(c) the Debtors may proceed to confirmation of the Plan without the obstacle of litigation of the Settlement Issues obstructing their path; and

(d) XO will be unable to exercise the Early Closing Election (as defined in the Purchase Agreement), which will allow XO to purchase the assets of the Debtors, rather than simply acquiring a controlling interest over the Debtors.

(e) there will be less likelihood of delay or reductions in distributions to creditors as a result of the Compromise and Settlement.

98. In sum, the Compromise and Settlement is fair and equitable and benefits the Debtors' creditors because:

- the Noteholders and will receive less than the potential amounts of their claims;
- other creditors, as a result, will receive a greater recovery than they would receive if the ATI Notes Trustee was successful in its litigation;
- the Debtors may proceed to confirmation of the Plan with out the obstacle of litigation with the ATI Notes Trustee, the Secured Lenders and the Committee regarding the allowance or disallowance of Intercompanies and the alleged violations of the Indentures and the Prepetition Credit Agreement and the attendant loss of significant value due to the erosion of value in the Debtors' estates;
- the Compromise and Settlement enables the closing of the Sale to occur as contemplated by the Purchase Agreement, as amended, which requires

that the Plan be confirmed by this Court on or before June 9, 2004 and that in the event that the Confirmation Order is not entered on or before such date, XO would have the right to make an Early Closing Election (as defined in the Purchase Agreement), which would allow XO to purchase the assets of the Debtors, rather than simply acquiring a controlling interest over the Debtors, which could, as a result of tax and other considerations, cause a reduction of cash available to the Debtors of approximately $40 million. Moreover, in the absence of a confirmed plan, the ongoing litigation between XO and the Debtors could threaten the Sale itself; and

- the Debtors' estates will not have to bear the time, expense and early of litigation of the Settlement Issues with the ATI Notes Trustee, the Committee and the Secured Lenders.

Accordingly, the Compromise and Settlement should be approved.

III. The Only Equitable Plan that Could Be Filed by the Debtors is the Substantive Consolidation Proposed by the Plan

99. The proposed substantive consolidation of the ATCW Debtors set forth in the Plan is fair. Substantive consolidation is appropriate where, as here, "(i) . . . creditors dealt with the [debtor] entities as a single economic unit and 'did not rely on their separate identity in extending credit,' or (ii) . . . the affairs of the debtors are so entangled that consolidation will benefit all creditors." Union Sav. Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Baking Co., Ltd.), 860 F.2d 515, 518 (2d Cir. 1988) (citations omitted; emphasis added); see also F.D.I.C. v. Colonial Realty Co., 966 F.2d 57, 59 (2d Cir. 1992) (citing two-part Augie/Restivo test); In re 599 Consumer Elecs., Inc., 195 B.R. 244 (S.D.N.Y. 1996) (same); In re Leslie Fay Cos., Inc., 207 B.R. 764 (Bankr. S.D.N.Y. 1997) (same); In re Gucci, 174 B.R. 401 (Bankr. S.D.N.Y. 1994) (same); In re I.R.C.C., Inc., 105 B.R. 237, 243 (Bankr. S.D.N.Y. 1989) (same).

100. Based on the facts and circumstances of these cases, the Debtors believe, and the Committee agrees, that by substantively consolidating and pooling the ATCW Debtors' assets and liabilities for distribution purposes, the Plan benefits all creditors. Substantive consolidation of the ATCW Debtors is compelled by, among other things, (i) the irreparable entanglement of

the ATCW Debtors, who did not manage their businesses along legal entity lines, (ii) the inability to allocate the ATCW Debtors' physical assets and receivables among legal entities, (iii) the inability to reconcile Intercompanies among the ATCW Debtors, and (iv) the corresponding inability to determine, with any accuracy, the distributable value of each of the ATCW Debtors. Accordingly, and because the Debtors' proposal of such substantive consolidation accords with applicable law, the Plan is appropriate.

101. As the evidence at trial will establish, the Debtors operated their business as one integrated whole, with ATI as a holding company filing public financials and the ATCW Debtors operating the Debtors' day-to-day business:

- trade creditors dealt with substantially all the ATCW Debtors as a single economic unit and did not rely on their separate identity in extending credit;
- the Debtors filed consolidated federal income tax returns and prepared financial statements, annual reports and other documents filed with the Securities and Exchange Commission on a consolidated basis;
- All financial information of the ATCW Debtors disseminated to the public, including to customers, suppliers, landlords, lenders and credit rating agencies, is prepared and presented on a consolidated basis;
- The ATCW Debtors share common directors and officers;
- The vast majority of ATCW Debtors exist solely to operate the ATCW business within an individual state jurisdiction;
- The ATCW Debtors share overhead, management, accounting and other related expenses;
- ATCW pays the expenses and salaries of the Subsidiaries; and
- All of the ATCW Debtors act from the same principal business location.

102. Here, the threat to ultimate creditor recoveries presented by the prospect of the Debtors remaining in chapter 11 while making futile efforts to create accurate consolidating financials, is far greater than in past cases, such as Drexel, in which substantive consolidation

was approved. With respect to the irreconcilable entanglement of the ATCW Debtors' affairs, testimony at trial will establish the following:

- The Debtors' cash is swept on a daily basis into a concentration account held by ATSC;
- Intercompany accounts receivable and accounts payable transactions have been recorded on a net basis (i.e., the system maintained a running balance that netted the intercompany accounts receivable and accounts payable transactions between two given legal entities). As a result, it would be extremely difficult, time consuming and potentially impossible to unravel and research the numerous transactions embedded in particular intercompany accounts receivable and accounts payable balances; and
- Intercompany transactions relating to periods prior to 1999 are recorded on a computerized legacy accounting system called Peachtree, which the Debtors no longer maintain and for which they no longer have relevant historical data files.

103. In light of these and myriad other issues, the Debtors, the Committee, the ATI Notes Trustee and the Secured Lenders and their professionals concluded that it would probably be impossible to generate accurate separate legal entity financial statements for the ATCW Debtors. The Committee submits that it would be incredibly difficult, and perhaps even impossible, to determine appropriate recoveries for holders of claims against each individual ATCW Debtor. Even if the value of each individual Subsidiary could be determined, it is unclear whether creditors of various subsidiaries would receive the same or differing recoveries (e.g. whether a creditor of a North Carolina Subsidiary would receive the same, less than or more than a creditor of a New York Subsidiary). Accordingly, as the recoveries of all creditors of the ATCW Debtors is the same under the Plan and many of the ATCW Debtors dealt with the ATCW Debtors as a single economic unit, it is fair to treat such creditors the same.

CONCLUSION

For all of the foregoing reasons, the Committee respectfully requests that the Court (a) confirm the Plan, (b) overrule all objections to Plan confirmation in their entirety and (c) grant such other relief as the Court deems just, equitable and proper.

Dated: New York, New York
June 5, 2004

AKIN GUMP STRAUSS HAUER & FELD LLP

/s/ Ira S. Dizengoff

Ira S. Dizengoff (ID-9980)
Philip C. Dublin (PD-4919)
Colin M. Adams (CA-2913)
Kenneth A. Davis (KD-9070)

590 Madison Avenue
New York, New York 10022
(212) 872-1000

Counsel to the Official Committee of Unsecured Creditors of Allegiance Telecom, Inc., et al.