Hearing Date and Time: May 3, 2004 at 10:00 a.m.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	**Chapter 11 Case No.**
	:	
Allegiance Telecom, Inc., et al.,	:	**03-13057 (RDD)**
	:	
Debtors.	:	**Jointly Administered**

DEBTORS' RESPONSE TO MOTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF ALLEGIANCE TELECOM, INC., ET AL., FOR AN ORDER UNDER 11 U.S.C. § 105(a) COMPELLING THE DEBTORS TO TERMINATE CERTAIN SENIOR EXECUTIVES

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

Allegiance Telecom, Inc. ("ATI") and its direct and indirect subsidiaries, as debtors and debtors-in-possession (collectively, the "Debtors"), in response to the Motion of the Official Committee of Unsecured Creditors of Allegiance Telecom, Inc., et al., for an Order Under 11 U.S.C. § 105(a) Compelling the Debtors to Terminate Certain Senior Executives (the "Motion"), respectfully represent as follows:

Preliminary Statement

1. Throughout these chapter 11 cases, the officers and directors of the Debtors have upheld the highest standard of ethical behavior and implemented model corporate governance procedures and standards. Specifically, the officers and directors actively participated in all significant aspects of these chapter 11 cases and, through these efforts, have achieved the following successes for the benefit of the Debtors' estates:

- The Debtors obtained approval for the sale of the assets of Allegiance Telecom, Inc. and Allegiance Telecom Companies Worldwide ("ATCW") and the common stock of substantially all of ATCW's subsidiaries (other than Shared Technologies Allegiance, Inc. ("STFI")) to XO Communications, Inc. ("XO") for $311 million in cash and 45.2 million shares of XO common stock. The purchase price paid by XO was significantly greater than the purchase price offered by the Debtors' "stalking horse bidder."
- The Debtors continued to improve the operations of STFI and, as a result, STFI is primed to emerge from chapter 11 as a going concern with significant value potential.
- The Debtors negotiated a consensual chapter 11 plan (the "Plan") with the statutory committee of unsecured creditors (the "Committee") appointed in these cases. The confirmation hearing to consider approval of the Plan is set for June 7, 2004.

2. In addition to the extraordinary efforts by the Debtors' officers and directors to maximize the value of the Debtors' estates and to maintain the Debtors' businesses as going concerns, the officers and directors assured that the Debtors complied with applicable non-bankruptcy law throughout these chapter 11 cases. One of the most important task that officers and directors of public companies have is to file annual and periodic reports with the securities and exchange commission (the "SEC"). The filing of these reports is intended "to insure the maintenance of fair and honest markets in securities transactions . . . ." Exchange Act Release 9660 (June 30, 1972). During these chapter 11 cases, both public bonds and common stock have been traded at relatively high volumes. Thus, the holders of these securities are

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entitled to receive relevant and timely public information regarding, among other things, the Debtors' business operations and financial health. Moreover, as the Debtors operated as going concerns throughout these chapter 11 cases, and at all times during and prior to these chapter 11 cases, took great care to maintain reliable and truthful financial records and reports, the information required for the preparation of the annual and periodic reports was available to enable the requisite officers to prepare and certify the reports without unreasonable expense or effort. The Debtors' next periodic report is due in a few weeks and, based on the federal securities laws, the Debtors are required to file it with the SEC.[1] Under the Sarbanes-Oxley Act of 2002, Royce Holland, the Debtors' chief executive officer (as well as the Chairman of the board of directors), and Thomas Lord, the Debtors' chief financial officer, are required to certify the reports.

3. Currently, the officers and directors of the Debtors are focused on assuring that all tasks necessary to obtain confirmation of the Plan and close the sale of the assets and common stock to XO. Indeed, on April 27, 2004, the board of directors held a meeting, together with its advisors, to be apprised of the status of the Debtors' chapter 11 cases and to assure that the Debtors are taking all actions reasonably necessary to complete these chapter 11 cases as smoothly as practicable. Based on the Motion (which will be defined and discussed below), the directors once again considered the Debtors' needs (and, specifically, whether the services of Messrs. Holland and Lord were necessary until confirmation of the Plan) through confirmation of the Plan. In so doing, the board of directors considered the Motion and the views of certain of

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[1] Even if the Debtors wished to cease filing periodic reports with the SEC and thereby deny its stockholders and creditors the same level of disclosure they received prior to the commencement of the Debtors' chapter 11 cases, the Debtors, to suspend their duty to file such reports, would be required to certify that they have less than 300 holders of record of its common stock. Pursuant to the SEC's definition of "holders of record" and a review of the stock registrar, the publicly-traded Debtors do not have less than 300 "holders of record" of its common stock. Thus, the Debtors are required to file their periodic reports.

the Debtors' managers and advisors. Based on this thoughtful consideration, the board of directors determined that the services of Messrs. Holland and Lord were necessary (as the Debtors believed prior to the Motion being filed) to comply with the federal securities laws, protect the value of the Debtors' estates and participate in completing the tasks required under the purchase agreement entered into between XO and the Debtors.

4. The Debtors are less than six weeks away from the confirmation hearing. To get from today to the confirmation hearing, the Debtors have numerous significant issues and activities to resolve and complete. Yet, inexplicably, at this critical time, the Committee filed the Motion, seeking to interfere with the Debtors' corporate governance by seeking an order compelling the Debtors to terminate Messrs. Holland and Lord immediately. At its core, the Motion disputes the Debtors' stated needs for the services of Messrs. Holland and Lord[2] and, without any factual or legal support, asks the Court to substitute the Committee's judgment for that of the Debtors' board of directors. In making this extraordinary and irresponsible Motion, the Committee did not investigate the facts (nor does it appear that the Committee's attorneys consulted with experts on federal securities law or conducted even a modicum of legal research) and, since the filing of the Motion, the Committee's attorneys have represented to the Debtors' attorneys that they will not have a witness at the hearing on the Motion to support the relief requested therein. Thus, this bald Motion essentially asserts that Messrs. Holland and Lord are not needed to enable the Debtors to file their form 10-Q with the SEC (further its states, in total

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[2] In the Motion, the Committee explains that the Debtors provided it with information regarding the continuing duties of Messrs. Holland and Lord. This is true. Mark Stachiw, the Senior Vice President and General Counsel of ATCW, sent an email to Shawn O'Donnell of CTA and Ira Dizengoff, an attorney for the Committee. The email included the following text: **"CONFIDENTIAL AND PROPRIETARY. CONTAINS PRIVATE INFORMATION OF THIRD PARTIES."** Despite this clear cautionary statement and the fact that information provided to the Committee is supposed to be held by the Committee in the strictest confidence, the Committee disclosed this information in a publicly filed document and Mr. Dizengoff disclosed this information in his publicly filed declaration supporting the Motion. Obviously, this intentional breach of trust creates an unfortunate dynamic between the Debtors and the Committee's advisors.

contravention of federal securities laws, that the Debtors do not need to file the 10-Q with the SEC) and the Debtors do not need Messrs. Holland and Lord to obtain the required consents in accordance with the purchase agreement between XO and the Debtors because Mark Tresnowski, the Executive Vice President and General Counsel, will be able to obtain such consents (this assertion is made despite the fact that Mr. Tresnowski will testify that the services of Mr. Holland and/or Lord may be needed to obtain the consents). Based on the Committee's erroneous assertions, it concludes that Messrs. Holland and Lord must be terminated immediately, which will allow the Debtors' estates to save $150,000 (this number is artificially inflated by more than 30 percent) and, thereby, preserve the value of the Debtors' estates.

5. To add insult to injury, after the filing of the Motion, the attorneys for the Debtors contacted the attorneys for the Committee to explain why Messrs. Holland and Lord were needed through confirmation and the substantial risk of harm to the estates that could befall it if Messrs. Holland and Lord were fired. In connection with this explanation, the Debtors requested that the Committee withdraw the Motion to protect the estates and eliminate any further costs associated with the Committee's prosecution and the Debtors' defense of the relief requested in the Motion. Unfortunately, the Committee would not heed to reason and refused to withdraw the Motion.

6. Based on the Committee's actions, the Debtors find themselves in an unfortunate and untenable situation. Rather than being able to focus exclusively on activities that benefit and enhance the value of the estates (and, thus, the constituency the Committee was appointed to represent), the Debtors are forced to respond to an extraordinary and baseless Motion. After significant consideration, the Debtors are unable to understand the true motivations of the Committee in filing the Motion and, as a result, believe the Committee's

motives must be questioned to determine whether its actions were designed in any way whatsoever to benefit its constituencies, the Debtors' unsecured creditors.

Response

I. There is No Legal Basis to Grant the Relief Requested in the Motion.

7. "The Second Circuit has proffered the general rule that corporate governance should remain uncompromised by a bankruptcy reorganization proceeding." In re Dark Horse Tavern, 189 B.R. 576, 581 (N.D.N.Y. 1995), citing In re Johns-Manville Corp., 801 F.2d 60,64 (2d Cir. 1986). "Thus, when a corporation is a debtor in possession, the board of directors continues to be vested with the authority to make decisions on behalf of the corporation." Dark Horse, 189 B.R. at 581, citing In re Potter Instrument Co., Inc., 593 F.2d 470, 474-75 (2d Cir. 1979).

8. It is axiomatic that the Debtor's officers and directors are vested with the authority to manage and operate the Debtors businesses. Such authority includes the right to make determinations regarding the employment needs of the Debtors between now and the date of the Confirmation Hearing. Absent the appointment of a trustee under section 1104 of the Bankruptcy Code, corporate law in the state of the Debtors' incorporation set the parameters for the Debtors' decision making process. In this circumstance, where the decision to retain Messrs. Holland and Lord through the date of confirmation of the Plan was made in good faith and with the sound business judgment of the board of directors, such decision should be upheld.

9. The Motion requests that the Court ignore established precedent concerning corporate decision-making. It attempts to break new and dangerous ground by requiring a debtor in possession to explain why it has decided to maintain the employment of certain officers. The Committee fails to provide any support for its request to compel the Debtors to terminate the employment of Messrs. Holland and Lord, baldly citing section 105(a)

of the Bankruptcy Code as the basis for the Motion. The Motion fails to provide any additional substantive provisions of the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure to justify the relief requested. As such, the Committee's request is wholly without legal basis.

10. Section 105(a) of the Bankruptcy Code provides, in relevant part, that the Court "may issue any order, process, or judgment that is necessary or appropriate *to carry out the provisions of [the Bankruptcy Code]*." 11 U.S.C. § 105(a) (emphasis added). By its terms, section 105(a) of the Bankruptcy Code "merely provides the court with equitable powers to further the substantive provisions of the code, it does not empower the court to create a cause of action otherwise unavailable under the bankruptcy code." New England Dairies, Inc. v Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.), 272 B.R. 66, 73 (S.D.N.Y. 2002); Hasset v. Bancohio Nat'l Bank (In re CIS Corporation), 172 B.R. 748, 757 (S.D.N.Y. 1994); accord Official Committee of Unsecured Creditors v. PSS Steamship Co., Inc. (In re Prudential Lines), 928 F.2d 565 (2d Cir.), cert. denied 502 U.S. 821, 116 L.Ed.2d 55, 112 S. Ct. 82 (1991). The Bankruptcy Code does not recognize the Committee's request. Granting the relief it requests would give section 105(a) of the Bankruptcy Code a life of its own, unfettered by the provisions of the Bankruptcy Code it is meant to serve. Accordingly, the Court should deny the Motion.

11. Apparently recognizing (although not acknowledging) this black-letter law, the Committee attempts to manufacture a basis for using section 105(a) of the Bankruptcy Code in support of its Motion. Specifically, the Committee asserts that the relief it seeks is "pursuant to section 105(a) of the Bankruptcy Code, in furtherance of the Modified Executive KERP Order."[3] The Committee further provides that the Court retains jurisdiction to resolve

[3] As defined in the Motion.

disputes under the Modified Executive KERP Order. The only conclusion that may be reached from this is that the Committee wants the Court to believe that the relief requested is tied to the Modified Executive KERP Order. This is completely untrue. There are no disputes under the Modified Executive KERP Order. Indeed, whether Messrs. Holland and Lord remain with the Debtors until confirmation or are terminated without cause, they will receive the full amount of their key employment retention payments in accordance with the Modified Executive KERP Order. The attempt to tie the Modified Executive KERP Order blatantly misinforms the Court and dishonestly makes an attempt of legal legerdemain.

12. The Committee cannot create its own cause of action, standard and remedy when none exists in the Bankruptcy Code. Accordingly, absent any legal basis for the Motion, the relief requested in the Motion should be denied.

II. <u>There is No Factual Basis to Grant the Relief Requested in the Motion.</u>

13. Amazingly, the Committee filed the Motion without any factual support or evidence for the relief requested therein. Moreover, the Committee will not have a witness at the hearing to support its assertions that the employment of Messrs. Holland and Lord is no longer necessary and their termination would benefit – rather than substantially harm – the Debtors' estates. Rather, the Committee takes information provided to it by the Debtors in confidence, discloses it in publicly filed documents (which were then reported on by the media, demonstrating how this frivolous Motion can be a vehicle used to impugn the reputations of Messrs. Holland and Lord notwithstanding the fact that they have served as models for how fiduciaries should comport themselves in a chapter 11 case) and erroneously concludes (again without factual support and, in fact, as demonstrated below, by misstating the law) that Messrs. Holland and Lord should be terminated.

A. Messrs. Holland and Lord are Necessary for the Debtors'

Compliance with Federal Securities Laws

14. The Debtors, as a public company, are required to comply with federal securities laws. As such, the Debtors must make periodic filings with the Securities and Exchange Commission (the "SEC"). Within the next few weeks, the Debtors must file their Form 10-Q for the first quarter of 2004. Under Section 906 of the Sarbanes-Oxley Act of 2002, the chief executive officer and the chief financial officer must certify and take all appropriate steps to enable them to attest that the relevant report "fully complies with the requirements of sections 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer." In accordance with the Sarbanes-Oxley Act of 2002, the chief executive officer and chief financial officer must perform specific due diligence with respect to the information set forth in the report. This task may not be delegated to another employee of a public corporation.

15. In addition, pursuant to rules promulgated under Section 302 of the Sarbanes-Oxley Act of 2002, the CEO and the CFO must certify in a 10-Q and a 10-K, among other things, that: (a) the report does not contain any untrue statement of fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading, (b) the financial statements, and other financial information included in the report fairly present in all material respects the financial condition, results of operations and cash flows of the company, (c) they have designed such disclosure controls and procedures to ensure that material information is made known to them, and (d) that they have evaluated the effectiveness of the company's disclosure controls and procedures.

16. Based on the Sarbanes-Oxley Act of 2002, Messrs. Holland and Lord, as CEO and CFO, respectively, must certify the Debtors' Form 10-Q. This task cannot be delegated to another employee of the Debtors. Thus, the continued employment of Messrs. Holland and Lord through the filing of the Debtors' Form 10-Q is necessary to ensure the Debtors comply with federal securities laws.

17. Notwithstanding the clear mandate of the Sarbanes-Oxley Act of 2002 and the critical importance of sound corporate governance, the Committee asserts that "the Debtors do not need to file periodic reports, like the 10-Q, with the SEC." The Committee attempts to justify this assertion by stating that "[d]ebtors routinely do not file periodic reports with the SEC"[4] and "the SEC (when requested to do so) has sanctioned" debtors to not file periodic reports (citing to numerous no-action letters). These attempts to justify the Committee's assertion ignore the facts and the law. Furthermore, the Debtors wish to file reports with the SEC in order to continue to provide the level of disclosure its creditors and stockholders received prior to the chapter 11 filing.

18. Notably, the Debtors are in no way relieved of their obligations to continue public filings with the SEC by nature of their status of chapter 11 debtors (and the fact that certain chapter 11 debtors have not filed periodic reports while in bankruptcy does not authorize the Debtors to do the same). Furthermore, the Committee is well aware that the Debtors have not requested a no-action letter from the SEC (interestingly, the Debtors have been complying with the federal securities laws throughout these chapter 11 cases without complaint

4 Incredibly, the Committee cites Worldcom, Inc. as an example of a debtor that did not file its periodic reports during its chapter 11 cases. As this Court is aware, Worldcom, Inc. was implicated in one of the largest corporate frauds in the history of the United States and only recently filed its restated financial statements for 2003. The Debtors cannot be faulted for electing not to use Worldcom, Inc. as a model for its own compliance with federal securities laws.

from the Committee until now – less than six weeks before the Confirmation Hearing). The Committee (or, at least, its attorneys) also know that the Debtors cannot rely on no-action letters sought and obtained by other companies. Even if they could, the facts supporting the no-action letters cited by the Committee are inapposite to the facts in these cases.[5] In any event, a no-action letter is obtained generally only after considerable legal expense and time.

19. The directors and officers of the Debtors take their responsibilities under the federal securities laws very seriously. Indeed, they believe that it is critical to be a model corporate citizen and to abide by strong corporate governance standards. In that regard, the directors and officers of the Debtors will comply with the federal securities laws and file the Debtors Form 10-Q in compliance with the Sarbanes-Oxley Act of 2002.

20. The Debtors also believe that the continued filing of quarterly and annual reports with the SEC and compliance with the federal securities laws is important to an accurate assessment of the value of the common stock of XO, which is a portion of the consideration the Debtors' estates will receive at the closing of the sale to XO. In effect, the sale transaction with XO is a merger of equals. XO will be integrating the Debtors' telecommunications business into its own, creating one of the largest competitive local exchange carriers in the United States. XO is also a public company and, as a result, holders of XO common stock may be keenly interested in the Debtors' financial situation and XO itself benefits from having the Debtors' periodic securities law filings to better form the basis for its own filings. The Debtors believe that their continued compliance with the federal securities laws, including the information contained in the Form 10-Q, will provide the shareholders of XO with up-to-date and complete public

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5 Importantly, a no-action letter does not serve to suspend a company's obligation to file periodic reports, but rather represents the statement of the staff of the Securities and Exchange Commission that they will not prosecute the company for its failure to fulfill such obligation. A public company's obligation to file periodic reports is never suspended.

information regarding the Debtors' financial and operational results, which could help maximize the value of the price of the common stock of XO for the benefit of the Debtors' estates.

B. The Motion Requests Relief That Will Harm The Debtors' Estates, Not Preserve Them

21. In addition to the harm arising from the Debtors' non-compliance with the federal securities laws, termination of Messrs. Holland's and Lord's employment at this time also will unnecessarily expose the estates to substantial risk of loss. Concerned that these losses could be substantial, the Debtors requested that the attorneys for the Committee reconsider prosecuting the instant specious motion because the Debtors' response to the Motion would require the Debtor to describe, with specificity, the losses to be incurred if the Motion were granted. See Cantor Letter. Following transmittal of the Cantor Letter, the Debtors described verbally for the Committee's attorneys the substantial risks of loss that would arise from the termination of Messrs. Holland and Lord at this time. Notwithstanding the Debtors' plea, the Creditors' Committee refused to withdraw the Motion.

22. Contemporaneously with the filing of this Response, the Debtors filed an affidavit of Mark Tresnowski, the Executive Vice President and General Counsel of the Debtors (the "Tresnowski Affidavit") under seal. As the attorneys for the Debtors explained to the attorneys for the Committee in the Cantor Letter, public disclosure of the harm associated with the termination of Messrs. Holland and Lord would provide a road map for claimants and other interested parties to exploit the Committee's folly. Accordingly, the Debtors obtained the authorization of the Court to file the Tresnowski Affidavit under seal and to have any testimony given by Mr. Tresnowski in support of the Debtors' Response given in camera.

23. As set forth in the Tresnowski Affidavit the risks associated with dismissal of Messrs. Holland and Lord could be substantial. As fiduciaries for the estates, the Debtors

cannot and will not (unless ordered by the Court, of course) accede to the Committee's unfounded demands and take risks that could adversely impact the value of the Debtors' estates. Comparing reality to the allegations in the Motion and Mr. Dizengoff's declaration, raises only one question: what were the Committee's motives for filing the Motion in the first place?[6]

D. The Continued Employment of Messrs. Holland and Lord is in the Best Interests of the Debtors' Estates.

24. The Debtors' board of directors, in accordance with applicable law, makes all determinations with respect to the hiring and firing of senior officers of the Debtors. Such decisions are based on the board's business judgment and are part of the Debtors' ordinary day-to-day operations.

25. In view of (a) the potential risks that could arise based on a termination of Messrs. Holland and Lord and (b) additional risks and tasks that require the attention of Messrs. Holland and Lord (as set forth in more detail in the Tresnowski Affidavit), the Debtors believe that the continued employment of Messrs. Holland and Lord is necessary to maintain and maximize the value of the Debtors' estates. The substantial risks that the Debtors would take in terminating its CEO and CFO less than six weeks prior to the Confirmation Date far outweigh the $77,000 in salary that Messrs. Holland and Lord will receive during this period.

26. The Debtors believe that this decision is an exercise of their sound business judgment and should be supported by the Court.

D. Reservation of Rights.

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[6] The ultimate hypocrisy is evident in the fact that the Committee, though apparently incredibly concerned about conserving funds, continues to retain CTA to provide operational advice (over two months after the Court's approval of the sale of substantially all of the Debtors assets to XO) at a cost to the Debtors' estates of $125,000 per month.

27. The relief requested by the Committee in the Motion clearly has no basis in law or fact. Costs already have been incurred in connection with the preparation and prosecution of the Motion and this Response. Additional consequential damages arising from the Motion, and the negative publicity surrounding the Motion, also may be incurred. Thus, the Debtors reserve all rights impose the cost of the instant sideshow on the Committee (and its professionals and members) pursuant to 28 U.S.C. § 1927, Bankruptcy Rule 9011 or otherwise, as and if appropriate.

Conclusion

WHEREFORE, for all of the foregoing reasons, the Debtors request that the Court deny the relief requested in the Motion and grant such other and further relief as the Court deems appropriate.

Dated: New York, New York
April 30, 2004

Respectfully submitted,

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