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HEARING DATE: 6/2/04
AT: 10:00 A.M.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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

**RESPONSE OF THE DEBTORS TO MOTION BY OPERATING COMPANY
SUBSIDIARIES OF VERIZON COMMUNICATIONS INC. FOR
TEMPORARY ALLOWANCE OF ITS CLAIMS FOR VOTING PURPOSES
PURSUANT TO FEDERAL RULE OF BANKRUPTCY PROCEDURE 3018**

Allegiance Telecom, Inc. and its direct and indirect subsidiaries, as debtors and debtors in possession (collectively, "Allegiance" or the "Debtors"), for their response to the Motion by Operating Company Subsidiaries of Verizon Communications Inc. (collectively, the "Verizon Companies") for temporary allowance of its claims for voting purposes pursuant to Federal Rule of Bankruptcy Procedure 3018, dated May 21, 2004 (the "Motion") respectfully state that:

Preliminary Statement

1. By the Motion, the Verizon Companies, and their parent, Verizon Communications Inc. ("Verizon") seek to have forty-six (46) claims filed by them against the Debtors (the "Verizon Claims"), which are the subject of objections by the

Debtors, temporarily allowed for purposes of voting on the Debtors' plan of reorganization. The Verizon Claims are addressed in the Debtors' fifth objection to certain proofs of claim filed by Verizon Communications, dated May 27, 2004 (the "Fifth Objection"). The Fifth Objection seeks to disallow all of the Verizon Claims on substantive grounds.

2. Verizon argues in the Motion that the Verizon Companies should be allowed to vote the Verizon Claims based on the contention that they hold substantial claims against the Debtors.

3. For the reasons set forth herein below, the Debtors believe that this Court should not permit the Verizon Companies to vote the Verizon Claims, as they are, in fact, susceptible to expungement based on meritorious substantive grounds.

Background

4. 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 and other institutional users. Allegiance offers its customers a variety of services, including:

- local and long distance voice services, including basic telephone services and advanced calling features;
- broadband and other Internet and data services, including high-speed Internet access, wide area network interconnection, domain name registration, web hosting, email and collocation services;
- integrated local long distance / Internet access offerings, which provide customers with integrated voice and Internet access over a single broadband line;
- equipment collocation, managed modem ports and Internet protocol traffic aggregation; and

- customer premise equipment sales and maintenance services.

Claims Bar Date

5. In the Debtors' chapter 11 cases, which were commenced on May 14, 2003, this Court entered an Order, dated September 23, 2003, pursuant to Bankruptcy Rule 3003(c)(3), (i) establishing a final date for filing proofs of claim in these chapter 11 cases, and (ii) approving the bar date notice and the notice and publication procedures (the "Bar Date Order"). The Bar Date Order, among other things, established November 26, 2003 (the "Bar Date") as the last date for all persons and entities (including governmental units) holding or wishing to assert pre-petition and certain other "Claims" (as such term is defined in 11 U.S.C. § 101(5)) against the Debtors to file a proof of claim with respect to each such Claim.

6. Within fifteen (15) days of the entry of the Bar Date Order, the Debtors' notice and claims agent, Bankruptcy Management Corporation ("BMC" or the "Voting Agent"), provided notice of the Bar Date by mailing (i) the notice of the Bar Date approved by the Court (the "Bar Date Notice") and (ii) a proof of claim form to the persons or entities listed in the Debtors' Schedule of Assets and Liabilities (the "Schedules"), which were previously filed with the Court, and to those additional parties listed in the Bar Date Order.

7. In addition, the Debtors published the Bar Date Notice in the USA Today (National Edition) on one occasion at least twenty-five (25) days before the Bar Date.

Plan of Reorganization

8. By an Order dated April 22, 2004, this Court, *inter alia*, (i) approved the Debtors' Second Amended Disclosure Statement Pursuant to Section

1125 of the Bankruptcy Code, dated April 22, 2004, relating to their Amended Joint Plan of Reorganization, as thereafter amended (the "Plan"), (ii) established various dates and procedures regarding voting to accept or reject the Plan, (iii) prescribed procedures for filing objections to confirmation of the Plan, and (iv) scheduled a hearing to consider confirmation of the Plan (the "Disclosure Statement Order").

9. Pursuant to the Disclosure Statement Order, ballots for voting on the Plan must be received by the Voting Agent by June 1, 2004. Further, the Disclosure Statement Order provides that holders of claims against the Debtors that are subject to objection based on liability and/or amount are entitled to vote their claims for or against Plan confirmation in the amount of one (\$1.00) dollar. The hearing to consider confirmation of the Plan is scheduled for June 7, 2004 at 10:00 a.m.

Debtors' Objections to the Verizon Claims

10. The Fifth Objection seeks to disallow all of the Verizon Claims on the following grounds: (i) the claim amounts are disputed, miscalculated and overstated; (ii) the claims are subject to set off rights of the Debtors for amounts due and owing by Verizon to the Debtors; and (iii) the claims are disallowed under section 502(d) of title 11 of the United States Code (the "Bankruptcy Code") as a result of the Debtors' preference claims against Verizon and the Verizon Companies.

Debtors' Opposition to the Motion

11. The Debtors object to the temporary allowance of the Verizon Claims for the reasons set forth below and requests that this Court deny the Motion. The Debtors have substantive objections to the Verizon Claims. These grounds

include that the claims are disputed and overstated, are subject to set-off rights of the Debtors and are disallowed pursuant to section 502(d) of the Bankruptcy Code. These are well-supported and valid objections and constitute a sufficient basis for the Court to deny temporary allowance of all of the Verizon Claims for Plan voting purposes.

Overstated Claims

12. The Debtors purchase various telecommunications facilities and services on a wholesale, retail, or other basis, from Verizon and the Verizon Companies. The Debtors use most of these services to provide its own integrated telecommunications products and services to Allegiance's customers. The Debtors also provide certain telecommunications facilities and services to the Verizon Companies that Verizon uses to provide services to its customers. The relationship between the Debtors and Verizon and the charges for the subject services is governed, among other things, by state and federal tariffs (the "Tariffs"), and Interconnection Agreements ("ICA").

13. Since telecommunication traffic flows in both directions, on a monthly basis both parties have amounts due to and from each other. In general, Allegiance reviews and analyzes charges from Verizon upon receipt of Verizon's invoices and, except as explained below, all charges that Allegiance determines are appropriate are paid, and the balance of the disputed charges are set aside for resolution at a later date. As these disputed charges accumulate, they can result in a significant amount. Periodically, representatives from both Allegiance and Verizon settle the disputed amounts but that has not occurred for these claims. Here, significant portions of the claims that the Verizon Companies assert as unpaid pre-

petition amounts continue to be disputed. Additionally, starting in late 2002, Verizon withheld payment for any valid amounts due to Allegiance. As a result, several months' later Allegiance ceased paying Verizon.

14. The Debtors have reviewed the Verizon Claims and have determined that such claims are overstated. Verizon has asserted amounts that are not due under the ICA or Tariffs, or has miscalculated or otherwise improperly asserted the amounts due by the Debtors to Verizon. The Debtors' books and records reflect that the total pre-petition amount actually invoiced by Verizon under the ICA and Tariffs is \$58,086,267. After taking into consideration the pre-petition disputed and overstated amounts of \$29,867,129 invoiced by Verizon per the Debtors' books and records, the aggregate of the Verizon Claims should be reduced to \$28,219,138.

15. In addition to the foregoing reductions, the Verizon Claims should be further reduced in amount based on certain rights of set off that the Debtors have against Verizon as discussed below.

Setoff Rights

16. Section 553 of the Bankruptcy Code preserves the non-bankruptcy rights of parties (creditors and debtors) to effect set off of mutual obligations. Allegiance's books and records show that the pre-petition claims in favor of the Debtors against Verizon arising under the ICA or Tariffs total \$28,892,264. Consequently, Allegiance may set off such amounts due against the Verizon Claims. After reduction of the Verizon Claims on account of the disputed and overstated amounts, the aggregate of the Verizon Claims must be further reduced by the set off amount of \$28,892,264. This results in the Verizon Claims being reduced to zero.

Section 502(d) Objection

17. The Debtors' review of its books and records revealed that on or within ninety (90) days before the commencement of the chapter 11 cases, the Debtors made one or more transfers by check, wire transfer or its equivalent directly to or for the benefit of Verizon and/or the Verizon Companies. The Debtors believe that these payments constitute preferential transfers (the "Preferential Transfers") avoidable under section 547 of the Bankruptcy Code.

18. Section 502(d) of the Bankruptcy Code provides:

Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

11 U.S.C. § 502(d).

19. The Debtors contend that they can assert preference actions against Verizon and/or the Verizon Companies in the aggregate amount of approximately \$486,000. Accordingly, pursuant to section 502(d), the Verizon Claims must be disallowed unless Verizon returns the Preferential Transfers to the Debtors.

20. After deducting the disputed amounts and the amount of the set-offs, the Debtors have a claim against Verizon of \$673,126, before Verizon returns the Preferential Transfers of \$486,000. Even allowing Verizon a claim for such returned Preferential Transfers and netting it against the \$673,126 that Verizon owes the Debtors, Verizon still does not have a claim against the Debtors.

Discussion

21. In deciding whether an objected to claim should be temporarily allowed for plan voting purposes courts examine the merits of the claim objection and how the debtors listed potential liabilities owing to the creditor in its schedules. See In re Stone Hedge Properties, 191 B.R. 59 (Bankr. M.D. Pa. 1995).

22. In the present case, Allegiance scheduled the majority of Verizon related claims as contingent, unliquidated and disputed. Thus, from early on in these chapter 11 cases, Verizon was on notice that the Debtors had serious issues with the validity of potential Verizon claims and the process by which Verizon might arrive at claim amounts. In fact, prior to the commencement of these chapter 11 cases, Allegiance was attempting to address discrepancies between the charges invoiced by Verizon and the amounts the Debtors' books and records reflected were owed between the parties. Those efforts were unsuccessful and as noted above, the parties ceased paying each other. Further, Verizon, as well as other major ICA providers that Allegiance has relationships with, such as SBC Telecommunications and the BellSouth Companies, have been in protracted discussions during the cases regarding the obligations running between them under the ICA and Tariffs. Therefore, there can be no question that Verizon has been long aware of the position of the Debtors concerning the Verizon Claims and the potential for objection to the claims.

23. The bases for the objections to the Verizon Claims are well founded. The Debtors have legitimate grounds to contest the overstated and improper charges asserted in the Verizon Claims. Likewise, the Verizon Claims do not take into account the significant pre-petition charges owed by Verizon to Allegiance under the ICA and Tariffs. Taken together, the Debtors' right of set off and the elimination of the

Verizon overcharges reduce the aggregate of the Verizon Claims to zero. Finally, the existence of the Preferential Transfers fully disallows the Verizon Claims.

24. The underlying purposes of the Bankruptcy Code are to be considered by the courts in evaluating a motion for temporary allowance of a claim. See Stone Hedge, at 65. By the relief sought in the Motion, Verizon seeks the ability to vote the full amount of claims for or against confirmation of the Plan that in face amount far exceed any amount of the actual obligations owed by Allegiance, if there is any such net obligations due by the Debtors. Though a creditor's right to vote on a plan of reorganization is not to be withheld lightly, the competing purposes of the Bankruptcy Code to ensure fairness and integrity in the voting process cannot be ignored. Verizon should not be permitted to wield disproportionate and unjustified influence in the voting on Plan confirmation by temporary allowance of its vastly inflated unsecured claims. To do so would be highly prejudicial to the rights of all of the holders of allowed unsecured claims against the Debtors. The voting of all of the Verizon Claims in the full amount of approximately \$ 60 million would unfairly dilute the impact of the votes of the rest of the unsecured creditors. Accordingly, this Court should deny the Motion.

[concluded on the following page]

WHEREFORE, the Debtors respectfully request that the Court (a) deny the Motion, seeking temporary allowance of the Verizon Claims for Plan voting purposes, and (b) grant such further relief as it deems just and proper under the circumstances.

Dated: New York, New York
May 28, 2004

Respectfully submitted,

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