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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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

MOTION OF THE DEBTORS PURSUANT TO SECTIONS 105(a) AND 363(b) OF THE BANKRUPTCY CODE FOR AN ORDER AUTHORIZING PAYMENT OF PREPETITION EMPLOYEE OBLIGATIONS

TO THE HONORABLE UNITED STATES BANKRUPTCY JUDGE:

Allegiance Telecom, Inc. and its subsidiaries, as debtors and debtors in possession (collectively, "Allegiance" or the "Debtors"), respectfully represent:

Introduction

1. On the date hereof (the "Commencement Date"), the Debtors each commenced with this Court a voluntary case under chapter 11 of title 11, United States Code (the "Bankruptcy Code"). The Debtors continue to be authorized to operate their business and manage their properties as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. Simultaneously with the filing of their petitions and this Motion, the Debtors have requested an order directing the joint administration of their chapter 11 cases pursuant to rule 1015(b) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules").

Jurisdiction

2. This Court has subject matter jurisdiction to consider and determine this motion pursuant to 28 U.S.C. § 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue is proper before this Court pursuant to 28 U.S.C. §§ 1408 and 1409.

An Overview of Allegiance's Business

3. 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, wholesale customers 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 colocation services;
- integrated local long distance/Internet access offerings, which provide customers with integrated voice and Internet access over a single broadband line;
- wholesale services to other regional and national service providers, including equipment colocation, managed modem ports and Internet protocol traffic aggregation; and
- customer premise equipment sales and maintenance services.

4. Allegiance serves more than 100,000 business customers in 36 markets. Allegiance employs approximately 3,560 people, of which approximately 97 employees are covered by collective bargaining agreements.

5. As of the Commencement Date, the Debtors have approximately $245 million of cash. As of December 31, 2002, the Debtors' consolidated books and records

reflected assets totaling approximately $1.441 billion and liabilities totaling approximately $1.397 billion. For the three months ending December 31, 2002, the Debtors, on a consolidated basis, reported revenues of approximately $204.91 million, EBITDA (i.e., earnings before interest, taxes, depreciation, amortization, non-cash deferred compensation expense and non-cash goodwill impairment charges) of approximately negative $34 million and net losses of approximately $120 million.

Allegiance is Critical to Promoting Sustainable
Competition in the Local Telecommunication Marketplace

The Telecommunications Act of 1996

6. In February of 1996, Congress enacted the Telecommunications Act of 1996 (the "Telecom Act"), with the stated purpose of:

> promot[ing] competition and reduc[ing] regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.

H.R. REP No. 104-204(I), 104th Cong. 1st Sess. 1995 (July 24, 1995), reprinted in 1996 U.S.C.C.A.N. 10, **10. In that regard, the Telecom Act required Incumbent Local Exchange Carriers, including the Regional Bell Operating Companies ("ILECs") – i.e., existing telecommunications monopolies – to allow newly created Competitive Local Exchange Carriers ("CLECs") to (a) interconnect with the ILECs, (b) access portions of the ILEC network and (c) collocate their equipment in ILEC facilities all at forward-looking cost based rates. In addition, CLECs were permitted to purchase ILEC services at wholesale prices and resell them to customers at retail prices.

7. The enactment of the Telecom Act spurred entrepreneurs to start hundreds of new businesses to compete in the local telecommunications marketplace. During the late 1990s, investors recognized the growth opportunity inherent in the opening of a competitive

local telecommunications marketplace and invested billions of dollars in equity and debt capital into a multitude of telecommunications companies primed to provide competing services to American consumers.

8. Funded with significant amounts of investment capital, two types of CLECs emerged. The first type of CLECs were "resellers". Specifically, "reseller" CLECs purchased telecommunications services from ILECs at a discount and resold the services to customers at a higher price. Thus, these CLECs simply offered consumers the same services supplied by ILECs - generally at lower prices. To be successful with this low margin business model, "reseller" CLECs invested their capital in sales and marketing efforts designed to acquire a substantial customer-base and attendant market-share in a relatively short period of time and ahead of their many competitors. However, because resellers were providing the identical services as the ILECs (with no differentiation) and were attempting to build a large market share in a highly competitive market, this business model was flawed and many in the telecommunications industry believe that the "resale" business will fail.

9. The second type of CLECs were "facilities-based" CLECs. These CLECs invested significant sums of money to build their own proprietary infrastructure and network in order to effectively compete with the ILECs. Specifically, facilities-based CLECs combined elements of an ILEC's network with their own to provide consumers with true differentiated services. As Michael Powell stated in his partial dissent to the FCC's 2003 Triennial Review:

> Facilities -based competition means a competitor can offer real differentiated service to consumers . . . . Facilities-based competitors own more of their own network and control more of their costs, thereby offering consumers real potential for lower prices. Facilities-based competitors offer greater rewards for the economy – buying more equipment from other suppliers . . . and creating more jobs. . . . . And, facilities providers create vital redundant networks that can serve own nation if other facilities are damaged by those hostile to our way of life.

F.C.C., 2003 Triennial Review - Open Meeting, Separate Statement of Chairman Michael R. Powell, dissenting in part (February 20, 2003) (transcript available at www.fcc.gov/wcb/cpd/triennial_review/). Allegiance is such a facilities-based CLEC with a nationwide network and a facility-based business strategy.

The Allegiance Nationwide Network – Servicing 36 Metropolitan Areas

10. In 1997, a management team of industry veterans launched Allegiance and focused on building a reliable nationwide network based on proven technologies, a nationwide direct sales force primarily focused on the small to medium sized business enterprise and information processing systems to support its operations. Allegiance was one of the first major local exchange carriers to open markets utilizing the "smart build" strategy. This strategy allowed a more rapid ramp-up in operations than the traditional competitive local exchange model in which extensive networks were built, including fiber networks, prior to the generation of significant revenues. In contrast, Allegiance's initial network build-out simply required (a) deploying digital switching platforms with local and long distance capability and (b) leasing transport facilities from the incumbent local exchange carriers and other competitive local exchange carriers to connect its switches with its transmission equipment colocated in the incumbent local exchange carrier's central offices. Once traffic volume justified further "success-based" investment, Allegiance leased dark fiber or built specific network segments. This strategy offered two major economic benefits. First, it enabled Allegiance to enter new markets with alacrity and reduce up-front capital requirements for entering individual markets prior to revenue generation. Second, in contrast to the traditional competitive local exchange carriers that generally built their networks in highly concentrated downtown areas due to the high cost of constructing fiber networks, Allegiance's business model enabled it to provide services to

customers in downtown areas as well as the more geographically dispersed, less competitive areas of its targeted markets.

11. Allegiance's initial business plan proposed entering into 24 of the largest metropolitan areas in the United States. Subsequently, management expanded its business plan to (a) increase the total number of target markets to 36, (b) increase its service area, i.e., its colocation "footprint" in its original 24 markets, and (c) acquire long-term rights to use dark fiber rings to replace network elements leased by the Debtors from the incumbent local exchange carriers.

12. In addition to internal growth, Allegiance's business plan included growth through strategic acquisitions. For example, in December 2001, Allegiance acquired certain assets of Intermedia Business Internet (the "Intermedia Acquisition"). The Intermedia Acquisition enabled Allegiance to (a) become a Tier 1 Internet access provider, (b) provide large quantities of data transmitted at high-speeds over the Internet to and from a customer's premises, (c) efficiently exchange traffic with other Internet backbone providers giving Allegiance greater control over its Internet access, and (d) leverage its local service presence to provide additional services to its target market. In June 2003, Allegiance acquired certain assets of Shared Technologies (the "Shared Technologies Acquisition"). The Shared Technologies Acquisition (a) added customer premises equipment sales, installation and maintenance to Allegiance's portfolio of integrated products and services, (b) strategically enhanced Allegiance's target market of small to medium size business enterprises, and (c) allowed Allegiance to provide a complete communications solution to business customers.

13. As of the date hereof, Allegiance provides its telecommunications services in major metropolitan areas across the United States, including the following 36 markets:

Atlanta, Austin, Baltimore, Boston, Chicago, Cleveland, Dallas, Denver, Detroit, Fort Lauderdale, Fort Worth, Houston, Long Island, Los Angeles, Miami, Minneapolis/St. Paul, New York City, Northern New Jersey, Oakland, Ontario/Riverside, CA, Orange County, Philadelphia, Phoenix, Pittsburgh, Portland, Sacramento, St. Louis, San Antonio, San Diego, San Francisco, San Jose, Seattle, Tampa, Washington, D.C., West Palm Beach/Boca Raton and White Plains. Allegiance is colocated in 849 central offices and has a Tier 1 Internet backbone.

The FCC Recognizes the Importance of Allegiance

14. Federal policy recognizes the importance of facilities-based CLECs and Allegiance is the model. In that regard, the Federal Communications Commission (the "FCC") recently published its latest rules for local competition in the *FCC Triennial Review*. In reviewing these rules, a Kaufman Bros. Equity Research Report, dated March 4, 2003, stated that "*Allegiance is the blueprint for local competition proposed by the FCC*." In addition, Kevin J. Martin, Commissioner of the FCC has noted:

> Allegiance has focused on building a business that adheres to the letter of the Telecom Act while leveraging the entrepreneurial spirit of the law, as well. Today, Allegiance stands as a model of what Congress intended in 1996, and what we hope to achieve in the years ahead – new entrants that have the opportunity to continue to invest in infrastructure, bring innovation and offer new service offerings to consumers in local markets that are open to fair and robust competition.

Kevin J. Martin, Commissioner, F.C.C., Address to the Telecommunications Law Conference and the Texas Chapter of the Federal Communications Bar Association (March 7, 2002) (transcript available at www.fcc.gov/Speeches/Martin/2002/spkjm203.html).

15. Thus, it is clear that Allegiance, by focusing on an intelligent – well thought out business model – building its own network and offering its consumers innovative services, is an integral player in the telecommunications marketplace and a model for the nation's policy of promoting sustainable facilities-based competition in the local

telecommunications arena. With an appropriate capital structure and a reduction in unnecessary costs, Allegiance believes it will be one of the most successful telecommunications companies in the United States.

Capital Structure of the Debtors

Capital Stock

16. Allegiance Telecom, Inc. 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, 2002, Allegiance Telecom, Inc. had (i) 124,830,110 shares of common stock issued and outstanding, with 295 registered holders and at least 20,000 beneficial owners, and (ii) no shares of preferred stock outstanding. Allegiance Telecom, Inc.'s common stock is publicly traded on the Nasdaq National Market under the symbol "ALGX."

17. Allegiance Telecom, Inc. owns 100% of the capital stock of Allegiance Telecom Company Worldwide ("ATCW"), and ATCW directly or indirectly owns 100% of the capital stock of each of the other Debtors.

Prepetition Notes

18. In 1998, Allegiance Telecom, Inc. issued two series of notes: (i) 11 3/4% Senior Discount Notes with a face value of $445 million, due on February 15, 2008 (the "Senior Discount Notes") and (ii) 12 7/8% Senior Notes with a face value of $205 million, due on May 15, 2008 (the "Senior Notes"). The Senior Discount Notes were issued under that certain Indenture, dated as of February 3, 1998, between Allegiance Telecom, Inc. and The Bank of New York, as Indenture Trustee. The Senior Notes were issued under that certain Indenture, dated as of July 7, 1998, between Allegiance Telecom, Inc. and The Bank of New York, as

Indenture Trustee. Neither the Senior Discount Notes nor the Senior Notes are secured by any assets of the Debtors or guaranteed by any of the Debtors.

Prepetition Credit Agreement

19. Prior to the Commencement Date, ATCW entered into that certain Credit and Guaranty Agreement, dated as of February 15, 2000, as amended as of November 27, 2002 (the "Prepetition Credit Agreement"), among ATCW, as borrower; all of the other Debtors, as guarantors; Goldman Sachs Credit Partners L.P. ("Goldman Sachs"), as syndication agent and sole lead arranger; General Electric Capital Corporation ("GECC") (as successor to Toronto Dominion (Texas), Inc.), as administrative agent, BankBoston, N.A. ("BankBoston") and Morgan Stanley Senior Funding, Inc. ("Morgan Stanley"), as co-documentation agents; Goldman Sachs, GECC, BankBoston, Morgan Stanley, certain managing agents, and lenders party thereto from time to time (collectively, the "Prepetition Lenders"). As of the Commencement Date, the amount outstanding under the Prepetition Credit Agreement was approximately $465.3 million. The Debtors have 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 its direct and indirect subsidiaries, including the capital stock owned by ATCW in each of its Debtor subsidiaries. As of the Commencement Date, there were 27 Prepetition Lenders under the Prepetition Credit Agreement.

Events Leading to Chapter 11 Filing

20. The distressed economic environment in the United States that followed the economic boom of the late 1990s has had a global and adverse impact on the telecommunications industry. In the late 1990s, in an effort to finance operations and build their networks, telecommunications companies borrowed significant amounts of money from lenders and the public through the issuance of debt. The resulting significant indebtedness incurred by

telecommunications companies, combined with poor economic conditions required many companies, including the Debtors, to focus on reducing their debt either through out of court restructurings or the chapter 11 process.

21. Many of Debtors' existing and potential customers have experienced their own financial difficulties, thereby decreasing customer demand for existing and new services. The financial difficulties of the Debtors' customers has led to non-payment, partial payment, or slow payment of bills for services provided by the Debtors. The financial instability of other companies in the telecommunications industry has adversely affected the willingness of potential customers to move their telecommunications services to the Debtors. In addition, certain of the Debtors' suppliers have requested deposits, letters of credit, or other types of security. Moreover, telecommunications carriers that owe reciprocal and/or intercarrier compensation to the Debtors have either refused to pay or failed to pay in a timely manner for the services provided by the Debtors.

22. As a consequence of the foregoing, the Debtors' business operations were adversely impacted and, due to revenue trends and continuing negative EBITDA, the Debtors determined that their current level of indebtedness needed to be significantly reduced. Thus, in order to maximize the long-term wealth generating capacity of their business operations, the Debtors, among other things, (a) established a special restructuring committee of the Board of Directors of Allegiance Telecom, Inc., (b) retained restructuring advisors, and (c) commenced extensive negotiations with their senior lenders and bondholders, as detailed below.

Negotiations with the Prepetition Lenders and the Ad Hoc Committee of Bondholders

23. The Debtors, in the exercise of their sound business judgment - and in recognition of the distressed economic environment and the need for the Debtors' businesses to focus on profitability instead of high revenue growth - determined that a meaningful de-

leveraging of their capital structure was crucial for the preservation and maximization of the value of their businesses. In that regard, the Debtors, in conjunction with their financial advisors and the Board of Directors of Allegiance Telecom, Inc., commenced the process of determining the appropriate capital structure for their business operations. After determining the appropriate capital structure, the Debtors commenced negotiations with the Prepetition Lenders and the Ad Hoc Committee (as defined below) to effectuate a restructuring transaction.

24. In October of 2002, Allegiance began negotiations with its Prepetition Lenders regarding a potential restructuring of its long-term debt. On November 27, 2003, Allegiance and its Prepetition Lenders entered into that certain First Amendment to the Prepetition Credit Agreement (the "Amendment"). Pursuant to the Amendment, the Debtors obtained a moratorium on their financial covenants through April 30, 2003. In exchange for the Amendment, Allegiance 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 Prepetition Lenders on account of debt owed under the Prepetition Credit Agreement. During the latter part of 2002 and to meet covenants under the Amendment, the Debtors significantly lowered their capital expenditures, reduced headcount, substantially decreased growth, eliminated less profitable products and services, and continued to optimize their existing network assets.

25. After entering into the Amendment, the Debtors commenced negotiations with the Prepetition Lenders to consummate a permanent restructuring. In connection with the negotiations regarding the permanent restructuring, the Debtors commenced negotiations with an *ad hoc* committee of noteholders, which is comprised of certain holders of the Senior Notes and the Senior Discount Notes (the "Ad Hoc Committee").

26. The Debtors, the Prepetition Lenders and the Ad Hoc Committee were not able to reach an agreement concerning the permanent restructuring prior to the April 30 deadline. On April 29, 2003, in order to avoid the occurrence of certain events of default under the Prepetition Credit Agreement, the Debtors and the Prepetition Lenders entered into a forbearance agreement (the "Forbearance Agreement"), which expires 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.

27. After entering into the Forbearance Agreement, the Debtors continued their negotiations with the Prepetition 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, in the exercise of their prudent business judgment, determined that it was in the best interests of all of their stakeholders and for the maximization of the value of their businesses to commence these chapter 11 cases and consummate a restructuring of their indebtedness under the auspices of this Court.

Wages, Salaries and Other Compensation

Payroll

28. In the ordinary course of their business, the Debtors incur payroll obligations to their employees for the performance of services. As referenced above, the Debtors currently employ approximately 3,560 employees. Of these, 1,997 are salaried employees, 1,466 are hourly employees, and 97 are covered by collective bargaining agreements and are paid on an hourly basis.

29. Generally, the Debtors' employees are paid bi-weekly for services rendered. The employees covered by collective bargaining agreements are paid weekly. On May 2, 2003, the Debtors paid wages to their non-union employees for the period April 19, 2003

through May 2, 2003. On May 8, 2003 and May 13, 2003, the Debtors paid wages to the employees covered by the two collective bargaining agreements for the prior week. In addition to general wages, as part of the Debtors' gross payroll, certain employees earn commissions on sales solicited, which are generally paid one month in arrears. The Debtors estimate that, as of the Commencement Date, approximately $9.4 million in gross wages, including commissions, will be owed to employees for services rendered prior to the Commencement Date ("Employee Payroll").

30. The Debtors also employ certain consultants, sales agents and independent contractors (the "Independent Contractors"), who are classified and paid separately from the Debtors' general employees. The Independent Contractors are typically paid two to four weeks in arrears. Sales agents are paid commissions based on sales made as well as monthly residuals on previous sales. The Debtors estimate that, as of the Commencement Date, the amount owed to Independent Contractors for services will not exceed $750,000.

31. In the ordinary course of business, certain employees and Independent Contractors who are paid by the Debtors do not cash their checks immediately. As a result, the Debtors anticipate that certain checks issued prior to the Commencement Date for Employee Payroll and Independent Contractors may not have "cleared" as of the Commencement Date. The Debtors estimate that the sum of such checks will be approximately $1.3 million.

Payroll Taxes

32. In accordance with applicable law, the Debtors are required to match from their own funds the social security and medicare taxes owed by their employees, and pay, based on a percentage of gross payroll, additional amounts for state and federal unemployment insurance and remit the same to the appropriate tax authorities (collectively, the "Payroll Tax

Obligations"). The Debtors estimate that, as of the Commencement Date, they will owe approximately $1.0 million in respect of Payroll Tax Obligations.

Vacation

33. In all states, except California, Illinois, and Colorado, the Debtors' employees receive vacation time based on their position and years of service. In accordance with the Debtors' vacation policy, any unused vacation time for these employees is forfeited. Employees in California, Illinois, and Colorado earn vacation on an accrual basis and are paid for unused vacation time at termination. The Debtors estimate that, as of the Commencement Date, approximately $500,000 will be owed to employees in the States of California, Illinois, and Colorado in respect of earned and unused vacation days.

Employee Benefits

34. In the ordinary course of their business, as is customary with most large companies, the Debtors have established various employee benefit plans and policies that provide employees with various benefits including (a) medical and dental insurance (the "Health Benefits"), (b) life and disability insurance coverage (the "Life and Disability Benefits"), (c) severance benefits (the "Severance Benefits"), (d) certain health, welfare, and pension benefits on behalf of union employees (the "Union Employee Benefits"), and (e) employee discounts, employee tuition reimbursement, stock option plan, and other similar benefits (collectively, the "Miscellaneous Benefits") (all Benefits referred to in paragraph 10(a) through paragraph 10(e) will be collectively referred to as the "Employee Benefits Programs").

Health Benefits

35. The Debtors maintain several fully insured medical and dental plans on behalf of their employees. The Debtors' insurance carriers are Connecticut General Life and Vision Service Plan. The Debtors estimate that, as of the Commencement Date, the aggregate

accrued and unpaid obligations for Health Benefits is approximately $4,430,000 (the “Health Benefit Obligations”).

Life and Disability Benefits

36. The Debtors provide their employees with Life and Disability Benefits. In that regard, in the ordinary course of business, the Debtors pay premiums to The Hartford Companies. The Debtors estimate that, as of the Commencement Date, the aggregate accrued and unpaid obligations for Life and Disability Benefits is approximately $70,000 (the “Life and Disability Obligations”).

Severance Benefits

37. The Debtors established a severance program for certain terminated employees. In accordance with this program, the Debtors remit payment to certain employees who were terminated prior to the Commencement Date (the “Severance Obligations”). The Debtors estimate that, as of the Commencement Date, the aggregated accrued and unpaid Severance Obligations is approximately $100,000. In addition to seeking authority to pay the Severance Obligation, the Debtors seek to continue their company policy of making severance payments to certain employees terminated by the Debtors on a postpetition basis.

Union Employee Benefits

38. The Debtors employ 97 employees (the “Union Employees”) who are covered by one of the two collective bargaining agreements entered into by a predecessor in interest to Shared Technologies Allegiance, Inc., one of the Debtors in these chapter 11 cases, with (a) IBEW Local 3, dated May 10, 2001, and (b) IBEW Local 164, dated August 15, 2002 (the “Union Agreements”). In connection with Union Agreements, the Debtors pay Union Employee Benefits on behalf of their Union Employees. The Debtors estimate that, as of the

Commencement Date, the amount of the aggregate accrued and unpaid Union Employee Benefits is approximately $110,000 (the "Union Obligations").

Miscellaneous Benefits

39. In addition to the foregoing, the Debtors make cash payments in respect of Miscellaneous Benefits, including, employee recognition, employee tuition reimbursement, 401(k) and stock option plans, and other similar benefits. The Debtors estimate that, as of the Commencement Date, the aggregate accrued and unpaid Miscellaneous Benefits will not exceed $150,000 (the "Miscellaneous Benefit Obligations").

40. The Debtors estimate that, as of the Commencement Date, the aggregate accrued and unpaid Health Benefit Obligations, Life and Disability Obligations, Severance Obligations, Union Obligations, and Miscellaneous Benefit Obligations, is approximately $4,860,000 (collectively, the "Employee Benefit Obligations").

Employee Payroll Deductions

41. Periodically, the Debtors are presented with garnishment or child support court orders requiring the Debtors to withhold employee wages to satisfy obligations of employees to third parties. The average weekly amount withheld on account of such court orders is approximately $30,000.

42. In addition, the Debtors withhold certain amounts from employee wages on a bi-weekly basis as requested by individual employees. These withholdings are related to various programs administered or offered by the Debtors, including: (a) investments in, or repayments to, the Debtors' 401(k) program, (b) employees' portion of health and life and disability insurance plans, (c) additional life insurance, and (d) other miscellaneous deductions (collectively with the sums deducted pursuant to court order, the "Employee Payroll

Deductions"). The average weekly amount withheld with respect to Employee Deductions is approximately $225,000.

43. The deductible amounts discussed in paragraphs 18 and 19 herein are included in the amounts detailed in the Wages, Salaries and Other Compensation section of this Motion. Thus, such amounts do not represent additional payments of prepetition obligations. Nonetheless, the Debtors seek authority to continue such programs in the ordinary course of business, and, to the extent any sums deducted have not yet been applied for their designated purpose, the Debtors seek authority to do so.

Reimbursable Business Expenses

44. As is customary with businesses comparable to the Debtors, the Debtors reimburse their employees for reasonable business expenses incurred in the performance of their duties (the "Reimbursable Business Expenses"). Reimbursable Business Expenses primarily arise in connection with employee business travel required by the Debtors in the ordinary course of business and miscellaneous out-of-pocket business expenses. In addition, periodically, the Debtors provide relocation expense reimbursements to certain of their employees. Pursuant to individual agreements with the Debtors, such employees may be reimbursed for certain defined expenses, including temporary housing, moving expenses, and other costs attendant to relocation.

45. The Debtors estimate that, as of the Commencement Date, the amount owed in respect of Reimbursable Business Expenses is approximately $100,000. These amounts are payable only upon submission of appropriate documentation and approval. Moreover, the Debtors anticipate that certain checks issued prior to the Commencement Date in respect of the Reimbursable Business Expenses detailed above may not have "cleared" as of the

Commencement Date. The Debtors estimate that the sum of such checks should not exceed $25,000.

Relief Requested

46. By this Motion, the Debtors request that, pursuant to sections 105(a) and 363(b) of the Bankruptcy Code, the Court authorize the Debtors to pay the prepetition employee obligations described above, including all tax obligations relating thereto, and to continue their employee-related plans, programs, and policies, as they were in effect as of the Commencement Date, and to pay amounts in respect thereof as they come due in the ordinary course of business.

47. Specifically, the Debtors request the Court:

a. authorize the Debtors to (i) pay earned and unpaid wages, salaries, commissions, vacation pay, and other compensation, (ii) pay the Employee Benefits Obligations, (iii) satisfy and/or apply the Employee Payroll Deductions and (iv) pay any outstanding Reimbursable Business Expenses, as of the Commencement Date (collectively, the "Prepetition Employee Obligations");

b. authorize the Debtors to pay earned and unpaid Payroll Tax Obligations to the extent any such payments remain unpaid;

c. authorize the Debtors to continue to honor their plans, policies, and programs with respect to vacation, Employee Payroll Deductions, and Reimbursable Business Expenses as such plans, policies, and programs were in effect as of the Commencement Date, including the payment of prepetition amounts as they become due in the ordinary course of business without such conduct and payment to be deemed an assumption of such plans, policies, and programs;

d. authorize the Debtors to maintain their Employee Benefits Programs, including their health, dental, life, accident and disability insurance plans, and severance plans, on an uninterrupted basis, consistent with prepetition practices, and to pay any amounts that become due in the ordinary course of business all prepetition reimbursements, premiums, administrative fees, and other prepetition insurance obligations to the extent due and payable postpetition, without such conduct and payment to be deemed an assumption of such plans, policies, and programs;

e. authorize and direct the Debtors' banks to honor and pay all prepetition and postpetition checks issued or to be issued, and fund transfers requested or to be requested, by the Debtors in respect of the Prepetition Employee Obligations and Payroll Tax Obligations that were not honored or paid as of the Commencement Date to the extent sufficient funds are on deposit at such banks; and

f. authorize the Debtors to issue new postpetition checks or effect new fund transfers on account of the Prepetition Employee Obligations or Payroll Tax Obligations to replace any prepetition checks or fund transfer requests that may be dishonored or voided, and to reimburse their employees or the applicable tax authority, as the case may be, for any fees and costs incurred by them in connection with a dishonored or voided check or funds transfer.

Authority for Paying Prepetition Employee Obligations

48. Pursuant to sections 507(a)(3) and 507(a)(4) of the Bankruptcy Code, claims in an amount up to $4,650 per employee against the Debtors for "wages, salaries, or commissions, including vacation, severance and sick leave pay," earned within ninety days of the Commencement Date, and claims against the Debtors for contributions to employee benefit plans arising from services rendered within 180 days prior to the Commencement Date, are afforded unsecured priority status.

49. In addition, section 363(b)(1) of the Bankruptcy Code provides that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1). Section 105(a) of the Bankruptcy Code further provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." Id. § 105(a).

50. The Debtors believe that most of their employees are owed less than $4,650 on account of prepetition payroll and contributions to employee benefit plans arising from services rendered within 180 days prior to the Commencement Date. Accordingly, substantially all employee claims for wages and Employee Benefits Programs constitute priority

claims. The Debtors submit that the payment of unpaid wages and Employee Benefits at this time is necessary and appropriate. In addition, due to their "priority" status, the payment of amounts owed for wages and Employment Benefits Programs will only affect the timing, but not the amount, of such payment.

51. To the extent that any employee is owed in excess of $4,650 on account of prepetition wages and Employee Benefits, the Debtors submit that payment of such amounts is necessary and appropriate and is authorized under section 105(a) of the Bankruptcy Code pursuant to the "necessity of payment" doctrine. The "necessity of payment" doctrine "recognizes the existence of the judicial power to authorize a debtor in a reorganization case to pay prepetition claims where such payment is essential to the continued operation of the debtor." In re Ionosphere Clubs, Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989); In re Chateaugay Corp., 80 B.R. 279 (S.D.N.Y. 1987). This doctrine is consistent with the paramount goal of chapter 11 of "facilitating the continued operation and rehabilitation of the debtor." Ionosphere Clubs, 98 B.R. at 176. Similarly, the Debtors submit that payment of the Payroll Tax Obligations (which are trust fund obligations) is necessary, appropriate, and authorized under section 105(a) of the Bankruptcy Code.

52. It is patently evident that the continued operation of the Debtors' businesses and their successful reorganization depends upon the retention of the services of their employees and the maintenance of employee morale. The employees are critical to the Debtors' operations and are vital to the Debtors' reorganization efforts. The Debtors' employees interact daily with, among others, customers, vendors, and others whose continued relationships with the Debtors are essential to the Debtors' viability. A deterioration in employee morale at this critical juncture undoubtedly would have a devastating impact on the productivity and effectiveness of

the Debtors' workforce, the value of the Debtors' assets and businesses, and the Debtors' ability to reorganize successfully in these chapter 11 cases. In addition, if the Debtors do not pay the Prepetition Employee Obligations, employees may leave the Debtors' employ and the Debtors may have difficulty in attracting replacement employees. Moreover, if the checks issued and fund transfers requested in payment of the Prepetition Employee Obligations are dishonored, or if such earned obligations are not timely paid postpetition, the Debtors' employees will suffer extreme personal hardship and may even be unable, in some instances, to pay their daily living expenses. Further, it would be inequitable to require the Debtors' employees to bear personally the business expenses that were incurred on behalf of the Debtors with the expectation they would be reimbursed. Consequently, it is equitable and paramount to authorize the Debtors to satisfy their employee-related obligations and continue their ordinary course employee plans, policies, and programs as in effect prior to the Commencement Date.

53. Accordingly, payment of all Prepetition Employee Obligations in accordance with the Debtors' prepetition business practices is in the best interests of the Debtors and their estates, and will enable the Debtors to continue to operate their business in an economic and efficient manner without disruption. The total amount to be paid if the authorization sought herein is granted is relatively modest compared with the size of the Debtors' estates and the importance of the Debtors' employees to their rehabilitation efforts.

54. The Debtors seek to pay the above-described obligations in accordance with the policies, plans, and programs in effect before the Commencement Date. Authorization of such payment by this Court is **not** to be deemed to constitute postpetition assumption or adoption of any policy, plan, or program pursuant to section 365 of the Bankruptcy Code. The

Debtors are in the process of reviewing these matters and reserve all their rights under the Bankruptcy Code with respect thereto.

55. Numerous courts in other large chapter 11 cases have approved payment of prepetition claims for compensation and benefits on the ground that payment of such claims was necessary to effectuate a successful reorganization. See, e.g., In re WorldCom, Inc., Ch. 11 Case No. 02-13533 (AJG) (Bankr. S.D.N.Y. July 21, 2002); In re Adelphia Communications Corp., Ch. 11 Case No. 02-41729 (REG) (Bankr. S.D.N.Y. June 25, 2002); In re Global Crossing Ltd., Ch. 11 Case No. 02-40187 (REG) (Bankr. S.D.N.Y. January 28, 2002); In re Ames Dep't Stores, Inc., Ch. 11 Case No. 01-42217 (REG) (Bankr. S.D.N.Y. August 20, 2001); In re Casual Male Corp., Ch. 11 Case No. 01-41404 (REG) (Bankr. S.D.N.Y. May 18, 2001).

56. As noted above, the Debtors submit that certain Payroll Tax Obligations constitute "trust fund" taxes. As a result, the payment of such taxes will not prejudice other creditors, given that the relevant taxing authorities would hold priority claims under section 507(a)(8) of the Bankruptcy Code in respect of such obligations. Moreover, the monies payable for trust fund taxes are not property of a debtor's estate. See Begier v. Internal Revenue Service, 496 U.S. 53 (1990).

Waiver of Memorandum of Law

57. This Motion includes citations to the applicable authorities and does not raise any novel issues of law. Accordingly, the Debtors respectfully request that the Court waive the requirement contained in rule 9013-1(b) of the Local Bankruptcy Rules for the Southern District of New York that a separate memorandum of law be submitted.

Notice

58. Notice of this Motion has been provided to: (a) the Office of the United States Trustee for the Southern District of New York; (b) attorneys for the Prepetition Lenders;

and (c) attorneys for the Ad Hoc Committee. In light of the nature of the relief requested herein, the Debtors submit that no other or further notice is required.

59. No previous request for the relief sought herein has been made by the Debtors to this or any other court.

WHEREFORE the Debtors respectfully request that the Court grant the Motion in all respects and grant the Debtors such other and further relief as it deems just and proper.

Dated: New York, New York
May 14, 2003

Respectfully submitted,

/s/ Matthew A. Cantor
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