

KIRKLAND & ELLIS  
Citigroup Center  
153 East 53<sup>rd</sup> Street  
New York, New York 10022-4675  
Telephone: (212) 446-4800  
Facsimile: (212) 446-4900  
Matthew A. Cantor (MC-7727)  
Jonathan S. Henes (JH-1979)

Attorneys for Debtors and Debtors in Possession

UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK

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

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**MOTION FOR AN ORDER AUTHORIZING THE DEBTORS  
TO HONOR CERTAIN PREPETITION OBLIGATIONS  
TO CUSTOMERS AND CONTINUE IN THE ORDINARY  
COURSE OF BUSINESS CUSTOMER PROGRAMS AND PRACTICES**

TO THE HONORABLE UNITED STATES BANKRUPTCY JUDGE:

Allegiance Telecom, Inc. and its direct and indirect 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 are authorized to operate their businesses and manage their properties as debtors in possession pursuant to sections 1107 and 1108 of the Bankruptcy Code. Simultaneously with the filing of their petitions and this Motion, the Debtors requested an order

for 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 within the meaning of 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), 104<sup>th</sup> Cong. 1<sup>st</sup> 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/web/cpd/triennial\\_review/](http://www.fcc.gov/web/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](http://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.

### **The Customer Programs**

28. Prior to the Commencement Date and in the ordinary course of their businesses, the Debtors engaged in certain practices and programs to develop and retain positive customer relationships in the marketplace for their products and services, to build customer loyalty, and to retain customers. These practices include the creation of new products and services, various customer discounts, promotional offers, warranties, service level guaranties, credits and other similar programs (collectively, the “Customer Practices”). The Debtors instituted the Customer Practices to match competitive practices, ensure customer satisfaction,

generate goodwill, retain current customers, attract new customers, and, ultimately, enhance net revenue. Certain of the Customer Practices are described with greater detail below for illustrative purposes.

### ***Customer Service Credits Program***

29. The Debtors provided customers with billing credits for disruptions, problems with customer service, billing errors, or customer overpayments (the “Customer Service Credits Program”). The Customer Service Credits Program acts to compensate customers who receive faulty or disrupted service, who are billed in error, or who have overpaid for services rendered (a “Dispute”). In the event a customer experiences a disruption in service or service quality below a certain commitment level or due to the Debtors’ network optimization activities, such customer may be eligible to receive a credit to their account in the form of a billing adjustment for certain amounts. In the event a customer is billed in error or has overpaid for services rendered, the customer is eligible to receive a credit to its account for such billing error or overpayment. Generally, no cash outlays are made to customers pursuant to the Customer Service Credits Program. However, some of the Debtors’ tariffs provide for cash outlays if a customer so requests one to be made instead of a credit to its account. In general, in order to receive a credit, the customer must alert the Debtors about a Dispute by (a) contacting the Debtors and requesting an “open trouble ticket” and (b) identifying the type and duration of the problem. If the Debtors confirm that a Dispute is valid and that a credit is either due under the customer’s contract, the Debtor’s tariff, or for other reasons, the Debtors will credit the customer’s account for a certain amount of the monthly recurring charges related to the impacted service billed during the service disruption and for other appropriate charges, or will credit the amount of the billing error or overpayment, and such credit will appear on a future bill.

### ***Customer Satisfaction Guarantee***

30. Prior to May 1, 2003, the Debtors offered a customer satisfaction guarantee (the “Customer Service Guarantee”) to new retail customers who switched to the Debtors’ local exchange or bundled voice/data services. This guarantee allowed a customer to switch back to their previous carrier, without incurring early termination fees, if such customer was not completely satisfied with the Debtors’ services within the first 90 days of service with the Debtors. As a part of this guarantee, the Debtors agreed to reimburse the customer for charges incurred in switching back to their previous carrier up to a maximum of \$100.00. In order to be reimbursed, the customer is required to produce a carrier’s bill showing such charges.

31. Beginning May 1, 2003, the Debtors started to offer a revised Customer Satisfaction Guarantee on a promotional basis. This revised offer will apply to new retail customers who are switching to the Debtors’ local exchange, bundled voice/data, or dedicated internet access services. The revised offer will permit a customer to terminate their service contract with the Debtors, without incurring early termination fees, if it is not completely satisfied with the Debtors’ service within the first 30 days of entering into such service contract with the Debtors.

32. As of the Commencement Date, the Debtors’ customers’ prepetition accrued but undistributed credit or reimbursement, pursuant to the Customer Service Credits Program and the Customer Satisfaction Guarantee, is approximately \$4.5 million.

### ***Equipment Warranties***

33. Certain of the Debtors warrant new equipment they sell, by providing repairs and replacement equipment as required (the “Warranty Program”). The Warranty Program enhances the Debtors’ ability to market their products. The Debtors believe that the warranty program is essential to its reorganization efforts.

### ***Customer Promotions***

34. Certain of the Customer Programs include a number of customer promotions or other activities (the “Customer Promotions”) to attract new customers, to entice current customers to purchase additional services, and to retain existing customers. The Customer Promotions encompass a variety of programs including, but not limited to, the Primary Rate ISDN Price Promotion, Free Month x2 Business Line Promotion, Total Communications & Digital Total Communications Price Promotion, Total Communications 385k/512k Broadband Upgrade Promotion, Dedicated Internet Access, DS-3 Internet Access Promotion, Free Long Distance Minutes Business Line Promotion, and Managed Modem Port Wholesale Service Promotion, whereby, according to the length of their service contracts, customers can receive incentives including, but not limited to, the following: (a) waiver of installation charges or account set-up fees; (b) reduced pricing; (c) free service (for limited periods of time); (d) credits (for new customers); and (e) competitor price matching. The Debtors seek authority to extend or continue, as the case may be, the Customer Promotions postpetition.

### **Relief Requested**

35. By this Motion, the Debtors respectfully request entry of an order, pursuant to sections 105(a), 363(c), 1107(a), and 1108 of the Bankruptcy Code, authorizing, but not directing, the Debtors, in their business judgment and sole discretion, to (a) perform all of their prepetition obligations related to the Customer Practices, and (b) continue, renew, replace, modify and implement new and/or terminate the Customer Practices in the ordinary course of business without further application to the Court. Subsequent to the Commencement Date, the Debtors desire to continue postpetition those Customer Practices that they believe will benefit their businesses. The Debtors believe that this relief is necessary to preserve their critical business relationships and goodwill for the benefit of their estates during these chapter 11 cases.

36. The great majority of the Customer Practices are provided to customers under existing programs. The Debtors anticipate that they will continue to provide the Customer Practices and perform their obligations under the Customer Practices throughout these chapter 11 cases. Moreover, certain obligations relating to the Customer Practices will not arise until after the Commencement Date, and, therefore, will constitute ordinary course postpetition expenditures of the Debtors. The Debtors, nonetheless, have filed this Motion to continue their prepetition Customer Practices under the terms and conditions set forth herein and to assure their customers that they will continue to honor and perform these Customer Practices.

**It is Necessary to Continue the Customer Practices**

37. The Debtors seek authority to continue the Customer Practices because, historically, these practices have been successful business strategies. In that regard, the implementation of the Customer Practices has been responsible for generating valuable customer goodwill, new and repeat business, as well as reducing customer claims. The Debtors believe that maintaining this customer goodwill and repeat business as well as reducing customer claims during these chapter 11 cases is essential to the continued vitality of their businesses and, ultimately, to their prospects for successfully reorganizing. The Debtors also believe that these chapter 11 cases could negatively influence customers' attitudes and behavior towards their products and services, particularly if the Debtors cannot continue the Customer Practices. In particular, the Debtors' goodwill and ongoing business relationships may erode if they are perceived to be unable or unwilling to fulfill their prepetition promises with respect to the Customer Practices. The same would be true if customers were to perceive that the Debtors could or would no longer offer the discounts and rewards that their competitors offer.

38. Given that their customers rely on certain Customer Practices, even a short delay or gap in the Debtors honoring their prepetition Customer Practices obligations could



irreparably harm the value of the Debtors' goodwill and opportunities for future new and repeat business. Therefore, the Debtors believe that the relief requested by this Motion must be made available as soon as possible during these chapter 11 cases.

### **Basis for Relief Requested**

39. Sections 1107(a) and 1108 of the Bankruptcy Code authorize a debtor in possession to continue to operate its business. Section 363(c) of the Bankruptcy Code authorizes a debtor in possession operating its business pursuant to section 1108 of the Bankruptcy Code to use property of the estate in the ordinary course of business without notice or a hearing. The Debtors submit that sections 363(c), 1107(a), and 1108 of the Bankruptcy Code permit them to continue, renew, replace, terminate, modify and implement, as the case may be, their Customer Practices in the ordinary course of business (other than to pay prepetition obligations related thereto) without further application to the Court.

40. To the extent continuation of the Customer Practices will result in the satisfaction of prepetition obligations of the Debtors, section 105(a) of the Bankruptcy Code authorizes the Court to 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). The purpose of section 105(a) is to ensure a bankruptcy court's power to take whatever action "is appropriate or necessary in aid of the exercise of its jurisdiction." 2 Collier on Bankruptcy, ¶ 105.01 at 105-4-6 (15th ed. 2002). A bankruptcy court's use of its equitable powers to "authorize the payment of prepetition debt when such payment is needed to facilitate the rehabilitation of the debtor is not a novel concept." In re Ionosphere Clubs, Inc., 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989). Under section 105(a), a court "can permit pre-plan payment of a prepetition obligation when essential to the continued operation of the debtor." In re NVR L.P., 147 B.R. 126, 127 (Bankr. E.D. Va. 1992); citing, Ionosphere Clubs, 98 B.R. at 177. The Debtors submit that the relief requested in

this Motion is critical to the Debtors and is justified under section 105(a) of the Bankruptcy Code.

41. The “necessity of payment” doctrine further supports the relief requested in this Motion. 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.” Ionosphere Clubs, 98 B.R. at 176; In re Chateaugay Corp., 80 B.R. 279 (S.D.N.Y. 1987); see also In re Lehigh & New England Railway Co., 657 F.2d 570, 581 (3rd Cir. 1981) (stating the “necessity of payment” doctrine “teaches no more than, if payment of a claim which arose prior to reorganization is essential to the continued operation of the [business] during reorganization, payment may be authorized even if it is made out of corpus.”). This doctrine is consistent with the paramount goal of chapter 11, which is to facilitate “the continued operation and rehabilitation of the debtor.” Ionosphere Clubs, 98 B.R. at 176; see also Dudley v. Mealey, 147 F.2d 268, 271 (2nd Cir. 1945), cert. denied, 325 U.S. 813 (1945) (“let [the debtor] once shut down, and it will lose much of its value. . . . Some priority to [the debtor’s prepetition suppliers] may be essential to preservation of the business.”).

42. As described, the loyalty and continued patronage of the Debtors’ customers is critical to their financial health and their reorganization prospects. Where retaining loyalty and patronage of customers is critical to a successful reorganization, courts in this district have granted relief similar to that requested here. See e.g., In re Formica Corporation, Ch. 11 Case No. 02-10969 (Bankr. S.D.N.Y. March 5, 2002); In re Teligent, Inc., Ch. 11 Case No. 01-12974 (Bankr. S.D.N.Y. May 24, 2001); In re Lechters N.Y.C., Inc., Ch. 11 Case No. 01-41432 (Bankr. S.D.N.Y. May 21, 2001); In re AI Realty Marketing of New York, Inc., Ch. 11 Case No.

01-40252 (Bankr. S.D.N.Y. February 6, 2001); In re Singer Co. NV, Ch. 11 Case No. 99-10578 (Bankr. S.D.N.Y. September 13, 1999).

43. Continuing the Debtors' historical Customer Practices is crucial to the future of the Debtors' businesses. The Debtors' success in reorganizing their businesses depends significantly on their reputation and retaining the goodwill of their customers. The Debtors' customers rely on the Customer Practices. The Customer Practices are consistent with industry practices and with the Debtors' historical business practices. The Debtors' inability to honor their Customer Practices would place them at a severe disadvantage relative to their competitors in the marketplace, potentially resulting in a significant imbalance between the Debtors and their competitors. Failing to continue the Customer Practices described herein will irreparably harm Debtors' business reputation and influence current and potential customers to do business with the Debtors' competitors. Such consequences would severely undermine the Debtors' reorganization efforts.

44. The Debtors' creditors will also benefit from the relief sought herein. If the Debtors are prohibited from honoring prepetition obligations and maintaining the Customer Practices consistent with their past business practices, then customers' lost confidence in the Debtors will damage the Debtors' businesses to an extent that far exceeds the cost associated with honoring prepetition obligations and continuing such practices. The requested order will protect the Debtors' goodwill during this critical time and enhance the Debtors' ability to generate future revenue.

45. Accordingly, the Debtors request that they be authorized, in their business judgment, to (a) perform and honor such of their prepetition obligations under the Customer Practices as they deem appropriate in the ordinary course of their business, and (b) continue,

renew, replace, modify, implement new, and/or terminate such of the Customer Practices as they deem appropriate in the ordinary course of business without further application to the Court.

46. The Debtors also request that the order approving this Motion direct and authorize the Debtors' banks to process, honor, and pay, to the extent of funds on deposit, any and all prepetition checks or wire transfer requests issued by the Debtors in respect of any prepetition obligations relating to the Customer Practices prior to, or after the commencement of these chapter 11 cases.

47. Nothing contained herein is intended or should be construed as (a) an admission as to the validity of any claim against the Debtors, (b) a waiver of the Debtors' rights to dispute any claim, or (c) an approval or assumption of any agreement, contract or lease under section 365 of the Bankruptcy Code.

#### **Waiver of Memorandum of Law**

48. Because there are no novel issues of law presented herein, the Debtors respectfully request that the Court waive the requirement that the Debtors file a memorandum of law in support of this Motion pursuant to rule 9013-1(b) of Local Bankruptcy Rules for the Southern District of New York.

#### **Notice**

49. 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.

#### **No Prior Request**

50. No prior motion for the relief requested herein has been made to this or any other Court.

WHEREFORE, the Debtors respectfully request that the Court enter an Order, substantially in the form attached hereto, authorizing, but not directing, the Debtors, in their business judgment, to (a) perform such of their prepetition obligations related to the Customer Practices as the Debtors see fit, and (b) continue, renew, replace, modify, implement new and/or terminate such of the Customer Practices as the Debtors see fit, in the ordinary course of business without further application to the Court, and (c) granting such other and further relief as the Court deems appropriate.

Dated: New York, New York  
May 14, 2003

Respectfully submitted,

/s/ Matthew A. Cantor

Matthew A. Cantor (MC-7727)

Jonathan S. Henes (JH-1979)

KIRKLAND & ELLIS

Citigroup Center

153 East 53<sup>rd</sup> Street

New York, New York 10022-4675

Telephone: (212) 446-4800

Facsimile: (212) 446-4900

Attorneys for Debtors and Debtors in Possession