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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.,	:	03-13057 (RDD)
	:	
Debtors.	:	Jointly Administered
	X	

MOTION OF THE DEBTORS, PURSUANT TO SECTIONS 105(a) AND 363 OF THE BANKRUPTCY CODE, FOR AN ORDER AUTHORIZING THE PAYMENT OF YEAR-END BONUSES TO CERTAIN OF THE DEBTORS' EMPLOYEES

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

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

Jurisdiction

1. 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.

Introduction

2. On May 14, 2003 (the "Commencement Date"), each of the Debtors commenced with this Court a voluntary case under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). The Debtors are authorized to operate their business and

manage their properties as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. The Debtors' chapter 11 cases have been consolidated for procedural purposes only and are being jointly administered pursuant to rule 1015(b) of the Federal Rules of Bankruptcy Procedure.

3. No trustee or examiner has been appointed in these chapter 11 cases. On May 28, 2003, pursuant to section 1102 of the Bankruptcy Code, the United States Trustee for the Southern District of New York (the "U.S. Trustee") appointed a statutory committee of unsecured creditors (the "Creditors Committee") in these chapter 11 cases.

Background

4. The Debtors are facilities-based national local exchange carriers that provide 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. The Debtors offer their 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;
- 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.

5. As of September 30, 2003, Allegiance served more than 100,000 business customers in major markets throughout the United States. As of September 30, 2003, Allegiance employed approximately 2,912 people, of which approximately 98 employees were covered by collective bargaining agreements.

6. As of September 30, 2003, the Debtors had approximately $284.1 million of unrestricted cash on hand. As of September 30, 2003, the Debtors' consolidated books and records reflected assets totaling approximately $1.226 billion and liabilities totaling approximately $1.455 billion. For the nine months ending September 30, 2003, the Debtors, on a consolidated basis, reported revenues of approximately $589.4 million and net losses of approximately $275.6 million

7. On December 18, 2003, the Debtors filed their motion for orders, pursuant to sections 105(a), 363, 365 and 1146(c) of the Bankruptcy Code: (a) (i) fixing the time, date and place for the bidding procedures hearing and (ii) approving the no-shop provisions set forth in the asset purchase agreement (the "APA") with Qwest Communications International Inc. ("Qwest"); (b) (i) establishing bidding procedures and bid protections in connection with the sale of substantially all of the assets of the Debtors, (ii) approving the form and manner of notices, (iii) approving the asset purchase agreement subject to higher and better offers and (iv) setting a sale approval hearing date; and (c) (i) approving the sale (the "Sale") to Qwest free and clear of all liens, claims and encumbrances, (ii) authorizing the assumption and assignment of certain executory contracts and unexpired leases and (iii) granting related relief.

8. Notably, section 7.2(g) of the APA provides that the payment of year-end bonuses by the Debtors to bonus-eligible employees in an amount not to exceed $10.7 million (exclusive of applicable employer taxes) is a condition precedent to the closing of the Sale. See APA, §7.2(g). Qwest required this provision to ensure that the Debtors would make all

reasonable efforts to retain, motivate and compensate their employees in the ordinary course of business, with the attendant effect being the maximization of the value of the Debtors' businesses.

Relief Requested

9. By this Motion, the Debtors seek entry of an order, pursuant to sections 105(a) and 363 of the Bankruptcy Code, authorizing the payment of year-end bonuses for 2003 (the "Year-End Bonuses") to certain of the Debtors' employees. As set forth below, the Debtors submit that the payment of the Year-End Bonuses is in the ordinary course of business and, therefore, the authorization to make such payments is unnecessary.

10. The payment of the Year-End Bonuses is reflected in the Debtors' cash collateral budget (which is annexed to the Debtors' Amended Final Order Authorizing Use of Cash Collateral) and, in that regard, the Prepetition Lenders are supportive of the payment thereof. However, by letter, dated December 17, 2003, the attorneys for the Creditors' Committee informed the Debtors that the Creditors' Committee did not consent to the line item in the cash collateral budget reflecting the Year-End Bonuses. In addition, the letter (a) requested certain information regarding the Year-End Bonuses, (b) requested that the Debtors refrain from paying the Year-End Bonuses until such information was evaluated and (c) asserted that the payment of the Year-End Bonuses fell outside of the ordinary course of the Debtors' business. The Debtors have provided the Creditors' Committee with the requested information[1] and have been communicating with the chairman of the Creditors' Committee regarding the Creditors' Committee's concerns. The Debtors disagree with the Creditors' Committee's assertion that the payment of the Year-End Bonus is not a transaction in the ordinary course of

business; however, in the spirit of good faith and fair dealing, and out of an abundance of caution, the Debtors, by this Motion, are seeking authorization to pay the Year-End Bonuses.

Year-End Bonuses for 2003

Overview of Year-End Cash Bonus Program

11. Like many companies, a year-end bonus program has been part of the Debtors' compensation practices since the formation of Allegiance in 1997. In that regard, subject to the procedures described below, all salaried non-commissioned employees have been – and are – eligible to receive year-end annual cash bonuses. The amount of a year-end bonus is based on a target percentage of an employee's regular base annual salary. The target percentages generally range from 10% of annual base salary to 55% of annual base salary based on employee's position with the Debtors.[2]

12. The Debtors' procedure for determining year-end bonuses is as follows (the "Bonus Procedures"):

- During the Debtors' strategic planning and budgeting process for the following year, the Debtors determine and include the projected aggregate amount of year-end bonuses in their financial projections;

- In the last quarter of each year, Allegiance's Compensation Committee of the Board of Directors (the "Compensation Committee"), together with the Debtors' senior management team, determines whether the Debtors' financial and operational performance for the year have been at a level that justifies payment of the year-end bonuses as set forth in the financial projections;

- In determining the appropriate aggregate amount of year-end bonuses, the Debtors consider the following factors, among others, the Debtors' EBITDA[3] and whether the

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[1] In addition, earlier in these chapter 11 cases, the Debtors provided the Creditors' Committee's financial advisors with financial projections reflecting retention payments, which were authorized under the KERP Motion (as defined below), <u>and</u> the Year-End Bonuses.

[2] The amount of a year-end bonus for an executive at a level higher than a Senior Vice President is determined by the Compensation Committee of the Debtors' Board of Directors and can be higher than 55% of such executive's base annual salary.

[3] Earnings before deducting interest, taxes, depreciation and amortization (and excluding recurring non-cash charges to operations for the management ownership allocation charge, deferred compensation expense, and goodwill impairment charges).

Debtors met their performance goals, including reducing customer churn, controlling network expenses, successfully expanding the Debtors product offerings and market share and other similar factors;

- After the Compensation Committee makes a determination that the year-end bonuses will be paid and determines whether the projected aggregate amount of the year-end bonuses should be adjusted based on the Debtors' financial and operational performance, the Debtors' management makes a determination with respect to each employee whether such employee's performance justifies the payment of a year-end bonus and determines the amount of such bonus;

- After the Debtors' management makes an initial determination, department managers review the proposed year-end bonuses and suggest adjustments for year-end bonuses for each employee in that department;

- The proposals of the department managers are reviewed by the Debtors' Chief Operating Officer and senior management and, based on such proposals, the target percentages may be adjusted based on the employee's performance for the year; and

- In December of each year, the suggested bonus amounts are provided to the Compensation Committee for review and approval. The Compensation Committee, among other things, reviews and deliberates on any bonus payable to an employee with a rank of Senior Vice President or higher.

13. In following the Bonus Procedures, the Debtors' year-end bonuses for the years 1998 through and including 2001 were as follows:

- 1998: All bonus eligible employees received, subject to individual variations based on performance, bonuses equal to 100% of their "target" year-end bonuses.

- 1999: All bonus eligible employees received, subject to individual variations based on performance, bonuses equal to 100% of their "target" year-end bonuses.

- 2000: All bonus eligible employees received, subject to individual variations based on performance, bonuses equal to 100% of their "target" year-end bonuses, except senior executives had the option to receive "indexed stock option awards" in lieu of cash bonuses.

- 2001: Due to the downturn in the economy, generally, and the telecommunications industry, specifically, all bonus eligible employees received, subject to individual variations based on performance, bonuses equal to between 50% and 67% of their "target" year-end bonuses, except senior executives had the option to receive "indexed stock option awards" in lieu of cash bonuses.

14. 2002. The Debtors, in accordance with the Bonus Procedures, projected the aggregate amount of year-end bonuses for 2002 to be approximately $12.7 million. In

accordance with past practices, this amount was included in the Debtors' financial projections on an accrual basis. In the fall of 2002, the Debtors engaged in negotiations with their prepetition lenders (the "Prepetition Lenders") regarding an amendment of the Credit and Guaranty Agreement, dated as of February 15, 2000, among Allegiance Telecom Company Worldwide, as borrower; all of the other Debtors, as guarantors; General Electric Capital Corporation (as successor to Toronto Dominion (Texas), Inc.), as administrative agent, and lenders party thereto from time to time (the "Prepetition Credit Agreement"). On November 27, 2002, as a result of these negotiations, the Debtors entered into that certain First Amendment to the Prepetition Credit Agreement (the "First Amendment"). Pursuant to the First Amendment, the Debtors and the Prepetition Lenders agreed that the Debtors would not pay year-end bonuses at the end of 2002, but instead implement a retention bonus program that would provide cash incentive payments to key employees payable on or about May 1, 2003. See Schedule I to the First Amendment. In addition, the First Amendment provided that the amounts to be paid and the relevant performance metrics would be determined by the Debtors' Board of Directors based on a recommendation of the Compensation Committee. Based on the foregoing, the Debtors employed the Bonus Procedures and set the amounts to be paid under the retention bonus program at the approximate amount of the projected 2002 bonuses. Thus, the amount projected and accrued during 2002 for employee bonuses were allocated to the key employee retention bonus program. This action was taken based on the understanding by the Compensation Committee that the Debtors' normal ordinary course bonus program would continue in 2003. As such, the Debtors, consistent with past practices, set forth, on an accrual basis, in all of their financial reports filed with the Securities and Exchange Commission, as well as in their financial projections developed in connection with their restructuring efforts, the full amount of the Year-End Bonuses for 2003 developed by the Compensation Committee.

15. On August 11, 2003, the Debtors filed that certain Motion of the Debtors, Pursuant to Sections 105(a), 363(b)(1) and 365 of the Bankruptcy Code, for an Order Approving and Authorizing Key Employee Retention Program (the "KERP Motion").[4] This Court approved the KERP Motion pursuant to four separate orders, dated August 22, 2003, September 4, 2003, September 29, 2003 and November 7, 2003 (the "KERP Orders"). Pursuant to the KERP Orders, the key employee retention program was approved, subject to certain modifications relating to a number of employees, as requested by the Creditors Committee and the Prepetition Lenders.

16. 2003. In January 2003, the Debtors, in accordance with the Bonus Procedures, projected the aggregate amount of year-end bonuses for 2003 to be approximately \$10.6 million[5] and, in accordance with past practices, included such amount in their financial projections. On (a) September 19, 2003 and (b) September 22, 2003, the Debtors' management team and the Debtors' restructuring advisors, Impala Partners, LLC, met with the Prepetition Lenders and the Creditors' Committee, respectively, to provide both constituencies (and their advisors) with the proposed long-term business plan for the Debtors (the "Business Plan"). The consolidated statement of cash flows included the Business Plan reflected, among other things, (y) the payment of the retention bonuses under the KERP Motion and (z) the payment of the Year-End Bonuses.

17. In December 2003, the Debtors' Board of Directors determined that the Year-End Bonuses would be paid and determined that, based on the Debtors' financial and

[4] On November 5, 2003, the Debtors filed that certain Supplement to the Motion of the Debtors, Pursuant to Sections 105(a), 363(b)(1) and 365 of the Bankruptcy Code, for an Order approving Key Employee Retention Program as it Relates to Certain Remaining Key Executives.

[5] This amount is higher than the actual amount of the Year-End Bonuses set forth below due to an inclusion of a group of employees that subsequently were determined to be entitled to commissions and, consequently, not entitled to the Year-End Bonuses.

operational performance, that the Year-End Bonuses would be equal to 100% of their target amount, subject to the adjustment of the target percentages based on the performance of individual employees. Subsequently, the Debtors' senior management, at the recommendation of the department managers, made adjustments to the target percentages of the amount of the Year-End Bonuses. On December 23, 2003, the aggregate amount of the Year-End Bonuses were approved by the Compensation Committee.

18. The aggregate amount of Year-End Bonuses is approximately $9.8 million for 898 employees.[6] Notably, this amount represents approximately two-thirds of the amount that the Debtors spend each month for employee compensation and benefits. Out of the 898 employees, (a) approximately 749 employees are "rank and file" employees, whose Year-End Bonuses constitute 10% of their base annual salary, (b) approximately 135 employees hold managerial positions with the Debtors, whose Year-End Bonuses range from 20% to 40% of their base annual salary and (c) 14 employees are senior executives of the Debtors, whose Year-End Bonuses constitute 55% of their base salary (with the exception of the Debtor's Chief Executive Officer, whose Year-End Bonus was set at a target of 75% of his base annual salary and authorized at that level, and with the exception of three officers, whose target bonuses were set at 55% of their base salary, but were authorized at approximately 66% of their base annual salaries as a result of the recognized extraordinary efforts by these individuals in connection with the Debtors' restructuring efforts).

The Debtors' Financial Performance in 2003

19. In determining the amount of the Year-End Bonuses in accordance with the Bonus Procedures, the following relevant information was considered:

- EBITDA in 2003. Despite the negative impact of these chapter 11 cases on the Debtors' business, the Debtors' EBITDA for the past five months has been positive. Notably, the Debtors' EBITDA has increased from negative $23 million for the first quarter of 2003 to $1.7 million for the third quarter of 2003. The projected EBITDA for the fourth quarter of 2003 is $7 million. In addition, the Debtors' cash balance has increased from $245 million on the Commencement Date to $285 million in November 2003.

- Reduced Customer Churn Rate. In 2003, the Debtors have been consistently improving customer service metrics and maintaining a high quality of service, which is evidenced by a reduced customer churn rate from 2.8% for the third quarter of 2002 to 1.7% monthly or the third quarter of 2003. In addition, the Debtors have increased the quality of their billing and credit systems. As a result of these improvements in the Debtors' collection system, the "bad debt" expenses were reduced from 8.1% of the Debtors' revenues in October 2002 to 2.2% of the Debtors' revenues in October 2003.

- Reduction in Network Expenses. The Debtors have undertaken substantial initiatives to identify and execute nationwide network optimization activities for the reduction of network facilities for an annualized cost savings (year over year) of $110.0 million, with $86.5 million of this amount realized through September 2003. The Debtors anticipate that the full annualized savings will be realized by January 2004.

- SG&A Expense Savings. All of the Debtors' employees have contributed to the sales, general and administrative ("SG&A") expense savings by individually addressing controllable expenses, while managing to retain the core revenues. While the total projected SG&A savings (from January 2003 to January 2004) is $104.6 million, the realized annualized savings through September 2003 were ahead of the projected amount.

Applicable Authority

Section 363(c)(1)

20. As set forth above, the Debtors submit that the payment of the Year-End Bonuses is a transaction in the ordinary course of business and, therefore, Court authorization to make such payment is unnecessary. Nonetheless, due to the concerns raised by the Creditors'

[6] This amount excludes FICA and other employer taxes. The aggregate amount of the Year-End Bonuses, including FICA and employer taxes, is approximately $10.2 million.

Committee, and out of an abundance of caution, the Debtors' seek Court approval to pay the Year-End Bonuses.

21. Section 363(c)(1) of the Bankruptcy Code provides, in pertinent part, that:

> unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

See 11 U.S.C. 363(c)(1).

22. Neither the Bankruptcy Code nor its legislative history define the term "ordinary course" or provide guidance whether a particular transaction was conducted "in the ordinary course of business" under section 363 of the Bankruptcy Code. See, e.g., In re Enron Corp., No. 01-16034 (AJG), 2003 WL 1562202, at *15-16 (Banker. S.D.N.Y. 2003) (citations omitted).

23. Various courts within the Second Circuit have applied a two-step "horizontal and vertical test" in determining whether a transaction was conducted "in the ordinary course of business" for purposes of section 363 of the Bankruptcy Code. See, e.g., Medical Malpractice Insur. Assoc. v. Hirsch (In re Lavigne), 114 F.3d 379, 384 (2d Cir. 1997); In re Enron Corp., No. 01-16034 (AJG), 2003 WL 1562202, at *15; Chaney v. Official Committee of Unsecured Creditors of Crystal Apparel, Inc. (In re Crystal Apparel, Inc.), 207 B.R. 406, 409 (S.D.N.Y. 1997); In re Coordinated Apparel, Inc., 179 B.R. 40, 43 (Bankr. S.D.N.Y. 1995).

24. The two tests are (a) the "creditor's expectation test," also known as the "vertical test," and (b) the "industry-wide test," also known as the "horizontal test." In re Lavigne, 114 F.3d at 384. These tests are intended to be both expansive and flexible and both elements of this inquiry must be satisfied in order for a transaction to be within the ordinary

course of business. See In re Enron Corp., No. 01-16034 (AJG), 2003 WL 1562202, at *15; In re Crystal Apparel, 220 B.R. at 831.

25. The vertical test requires that a bankruptcy court consider whether the transaction imposes economic risks consistent with a hypothetical creditor's expectations measured from the time that the creditor chose to contract with a particular debtor. In re Lavigne, 114 F.3d at 385. The focus is on the debtor's prepetition business practices as compared to the debtor's postpetition conduct in an effort to determine whether there is any significant variance in the debtor's activity. See, e.g., In re Leslie Fay, 168 B .R. 294, 304 (Bankr. S.D.N.Y. 1994); Committee of Asbestos-Related Litigants v. Johns-Manville Corp. (In re Johns-Manville Corp.), 60 B.R. 612, 617 (Bankr. S.D.N.Y. 1986), rev'd on other grounds, 801 F.2d 60 (2d Cir.1986) ("there is no per se rule that provides that a debtor's variance from prepetition activities is evidence of an extraordinary transaction" but "the greater the degree of variance between the debtor's prepetition and postpetition activities, the stronger the inference may be that the proposed transaction is not in the ordinary course of business").

26. Demonstrating that the transaction occurred in the ordinary course of business "is required merely to assure that neither the debtor nor the creditor do anything abnormal to gain an advantage over other creditors …" In re Johns-Manville, 60 B.R. at 618 (citing In re Economy Miling Co., 37 B.R., 914, 922 (D.S.C. 1983)). Thus, "an extensive showing that such transaction occurred often, or even regularly, is not necessary. The transaction need not have been common; it need only be ordinary. A transaction can be ordinary and still occur only occasionally." Id.

27. The "horizontal" test involves an industry-wide comparative analysis of the debtor's business to other similar businesses and requires considering whether such other businesses would engage in the proposed transaction as ordinary business. In re Lavigne, 114

F.3d at 385. The focus of this test is extrinsic to the debtor's operations although ultimately the focus shifts back to the debtor's business for comparison. See In re Johns-Manville Corp., 60 B.R. at 618. Under the "horizontal" test, "a transaction occurs in the ordinary course when there is a showing that the transaction is the sort occurring in the day-to-day operation of the debtor's business, or businesses like it." See In re Enron Corp., at *17 (citations omitted).

28. Notably, courts "must exercise great deference in reviewing a corporation's decision to pay its employees." See In re Chrystal Apparel, 207 B.R. at 410 (holding that "golden parachute" employment contracts may constitute transactions undertaken in the ordinary course of business and remanding the case to the bankruptcy court to make such determination under "horizontal and vertical test"). In that regard, courts have clearly articulated "that section 363(c)(1) [of the Bankruptcy Code] authorizes a debtor to provide for employee compensation in routine situations." See In re Enron Corp., 2003 WL 1562202, at *18.

Sections 363(b) and 105(a)

29. Section 363(b)(1) of the Bankruptcy Code provides, in pertinent part 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). The use, sale, or lease of property of the estate, other than in the ordinary course of business, is authorized when there is a "sound business purpose" that justifies such action. See Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1070 (2d Cir. 1983).

30. Further, pursuant to section 105(a) of the Bankruptcy Code, "the court may issue any order, process, or judgment that is necessary to carry out the provisions of this title." 11 U.S.C. § 105(a). Under section 105(a) of the Bankruptcy Code, the Court has expansive equitable powers to fashion any order or decree that is in the interest of preserving or protecting the value of the Debtors' assets. See, e.g., In re Chinichian, 784 F.2d 1440, 1443 (9th

Cir. 1986) ("Section 105 [of the Bankruptcy Code] sets out the power of the bankruptcy court to fashion orders as necessary pursuant to the purposes of the Bankruptcy Code."); Bird v. Crown Convenience (In re NWFX, Inc.), 864 F.2d 588, 590 (8th Cir. 1988) ("The overriding consideration in bankruptcy . . . is that equitable principles govern"); In re Cooper Properties Liquidating Trust, Inc., 61 B.R. 531, 537 (Bankr. W.D. Tenn. 1986) ("the Bankruptcy Court is one of equity and as such it has a duty to protect whatever equities a debtor may have in property for the benefit of their creditors as long as that protection is implemented in a manner consistent with the bankruptcy laws").

Payment of the Year-End Bonuses Is in the Ordinary Course of the Debtors' Businesses

31. The Debtors submit that the (a) payment of the Year-End Bonuses is consistent with the Debtors' prepetition practices and (b) year-end bonuses are common for companies of the Debtors' size in the telecommunications industry. Accordingly, as described below, the payment of the Year-End Bonuses during these chapter 11 cases is in the ordinary course of Debtors' business. Nonetheless, out of an abundance of caution, by this Motion, the Debtors seek approval of payment of the Year-End Bonuses.

32. As set forth above, since 1997, a year-end bonus program has been part of the Debtors' compensation practices. The Debtors have consistently followed the Bonuses Procedures to determine whether to pay year-end bonuses to their employees. Notably, every year the Debtors have paid year-end bonuses to their employees (with the exception of one year when such bonuses where rolled over into the retention program as set forth in the KERP Motion). Consistent with their prepetition practices, in 2003, the Debtors followed the Bonuses Procedures in making their determination to pay the Year-End Bonuses. Consequently, the

Debtors submit that that the “vertical” test with respect to the payment of the Year-End Bonuses is met.

33. Further, the Debtors submit that it is typical for the companies of the Debtors’ size in the Debtors’ industry to pay discretionary year-end bonuses when corporate financial and operational performance justify payment of such bonuses. As set forth above, as a result of the hard work of the Debtors’ employees, the Debtors’ financial and operational performance, as well as cash balances, have improved significantly in 2003. The failure by the Debtors to reward this dedication and hard work in accordance with past practices and the expectations of their employees could have an adverse impact on the Debtors’ operations and the outcome of these chapter 11 cases. For this reason, as described above, the payment of the Year-End Bonuses is critically important to the Debtors and their estates, as well as Qwest, which is evidenced by the fact that its offer to acquire substantially all of the assets of the Debtor is conditioned on the payment of the Year-End Bonuses. Accordingly, the Debtors believe that payment of the Year-End Bonuses should be approved.

Payment of the Year-End Bonuses Is an
Exercise of the Debtors’ Sound Business Judgment

34. Even if the Court determines that the payment of the Year-End Bonuses is a transaction outside of the Debtors’ ordinary course of business, the Debtors submit that such payment should be approved under sections 363(b) and 105(a) of the Bankruptcy Code.

Reductions in Force and Increased
Responsibilities of the Debtors’ Employees

35. In connection with their restructuring efforts and the goal of achieving profitability and establishing a lower cost structure, the Debtors have reduced their employee headcount from 4,020 employees at the end of October 2002 to 2,905 employees at the end of October 2003. As a result, the Debtors’ remaining employees have experienced a substantial

increase in their roles and responsibilities as they have been required to take on the jobs of their former co-workers without any additional increase in their salaries. Accordingly, these reductions in force have immensely affected employee morale while significantly increasing their workload.

36. Despite the signification reductions in force, the Debtors' employees have managed to transfer responsibilities among the employees without any service disruptions or any significant effect on the Debtors' customer service. All employees were impacted by the headcount reductions--every employee has been asked to do more -- without any additional pay and with no assurances of their continued employment.

Potential Threat of Additional Employee Attrition if the Year-End Bonuses Are Not Paid

37. The financial expectations of the Debtors' employees have been frustrated as stock options and other equity compensation granted to the employees since the founding of the Debtors' business in 1997 has lost value as a consequence of the deterioration of the telecommunications industry in general and the precipitous decline of the common stock of Allegiance, Telecom, Inc.

38. As set forth above, pursuant to the KERP Orders, the key employee retention program was approved with certain modifications requested by the Creditors Committee and the Prepetition Lenders. In particular, under the original key employee retention program, the majority of employees were required to remain with the Debtors through December 31, 2003. At the request of the Prepetition Lenders, the key employee retention program was modified to require employees to stay through confirmation of the Debtors' plan of reorganization. This modification has been negatively received by the Debtors' rank and file employees that constitute the majority of the employees receiving the Year-End Bonuses. This

modification was perceived as the attempt of the Debtors' management to 're-trade' the compensation arrangement that has been agreed upon prior to the Commencement Date. As a result, the vast majority of Debtors' "rank and file" employees that were not receiving any retention payments after the Commencement Date refused to sign the amendments to their retention agreements requiring them to stay through the date of confirmation of reorganization of the Debtors.

39. The Debtors believe that it is crucial to maintain the trust of their employees and adequately compensate them, in accordance with past practices, for their exceptional performance in 2003. With the execution of the Qwest APA, the Debtors' embarked on a sale process that, by its very nature, creates job insecurity for all of the Debtors' employees, especially senior management, many of whom have already been told that they will not be offered employment by Qwest. After months of seeking to formulate a stand-alone restructuring plan, the Debtors' Board of Directors determined that selling the business would maximize value for the Debtors' estates and, therefore, a sale should not only be pursued, but should be pursued despite the lack of assurances that employment opportunities would be offered by a particular bidder for employees of the Debtors.[7] Nonetheless, the Debtor's Board of Directors is mindful that the current sale process introduces significant uncertainty for the Debtors' employees at a time when such employees' continued performance is critical so that the sale can be consummated at the anticipated price. In that regard, the APA provides for certain purchase price reductions if the Debtors' end user sales or line installations fall below specified levels. On the other hand, the maximization of cash by the Debtors inures to the direct benefit of the Debtor's estates - not to Qwest. Furthermore, the sale requires enormous additional effort on the

part of the Debtors' employees as they must work with the bidder to groom network facilities, re-examine contractual commitments and otherwise seek to ensure an eventual merging of two nationwide communications networks to ensure a seamless integration thereof immediately upon consummation of the acquisition. It is the business judgment of the Debtors that any deviation from ordinary course bonus practices would be extremely unwise in the context of trying to accomplish these monumental objectives in conjunction with a sale of substantially all of the Debtors' assets to Qwest or another bidder.

40. Importantly, as the economy and job opportunities continue to improve, the Debtors' employees may choose to pursue alternative employment or may be lured away by lucrative offers from competitors of the Debtors to find job security and better compensation. If the Debtors fail to pay the Year-End Bonuses, the Debtors may experience a substantial number of employee resignations. It would be difficult, if not impossible, to replace these employees. Their loss at this critical juncture of these chapter 11 cases could have a disastrous impact on the Debtors' sale and restructuring efforts.

41. Accordingly, the Debtors have determined, in their sound judgment, that the payment of the Year-End Bonuses to their employees is in the best interests of their estates and all parties in interest. In making the foregoing determination, the Debtors submit that the costs of the payment of the Year-End Bonuses far outweigh the value would be lost as a result of the (a) business disincentives created for employees, (b) deterioration in value of the Debtors' estates from the loss of their employees and (c) the time and expense of recruiting and hiring replacement personnel. Moreover, the Debtors believe that the approval of the payment of the Year-End Bonuses will boost employee morale, enable the Debtors to maintain their employees'

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[7] It is important to note that the Debtors made extraordinary efforts in an attempt to procure employment for their (Continued…)

experience, knowledge and dedication and discourage employee. The Debtors submit that the approval and authorization of the payment of the Year-End Bonuses is absolutely essential to the Debtors' continued operations and restructuring efforts. Accordingly, the relief requested herein should be approved.

Waiver of Memorandum of Law

42. 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

43. This Notice has been provided to (a) the U.S. Trustee; (b) attorneys for the Prepetition Lenders; (c) attorneys for the Creditors Committee and (d) all other parties on the Master Service List maintained in these chapter 11 cases. In light of the nature of the relief requested herein, the Debtors submit that no other or further notice is required.

No Prior Request

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

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employees with Qwest after the consummation of the sale.

WHEREFORE the Debtors respectfully request that the Court enter orders substantially in the form annexed hereto (i) granting the Motion; (ii) approving and authorizing the payment of the Year-End Bonuses and (iii) granting the Debtors such other and further relief as it deems just and proper.

Dated: New York, New York
December 24, 2003

Respectfully submitted,

/s/ Jonathan S. Henes

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