Hearing Date and Time: January 9, 2004 at 10:00 a.m.

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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	

DEBTORS' REPLY TO OBJECTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF ALLEGIANCE TELECOM, INC., ET AL., TO THE DEBTORS' MOTION FOR APPROVAL OF BIDDING PROCEDURES AND BID PROTECTIONS IN CONNECTION WITH THE SALE OF SUBSTANTIALLY ALL OF THE ASSETS OF THE DEBTORS AND APPROVING THE FORM AND MANNER OF NOTICES IN CONNECTION THEREWITH

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

In response to the objection (the "Objection") of the official committee of unsecured creditors (the "Committee") to Debtors' 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 With Qwest Communications International, Inc.; (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 to Qwest Communications International, Inc. Free and Clear of All Liens, Claims and Assignment of Certain Executory Contracts and Unexpired Leases and (III) Granting Related Relief (the "Motion"), Allegiance Telecom, Inc. and its direct and indirect subsidiaries, as debtors and debtors-in-possession (collectively, the "Debtors"), respectfully represent as follows:

Preliminary Statement

1. The Court should overrule the objection of the Committee to the proposed Bidding Procedures (as defined in the Motion). The sale of substantially all of the Debtors' assets to Qwest pursuant to an orderly sale process is the culmination of months of painstaking effort by the Debtors and their professionals to obtain for the Debtors' estates a valuable transaction that assures significant recoveries to creditors. Indeed, the Purchase Agreement will facilitate the Debtors' prepetition lenders receiving payment in full (i.e., approximately $480 million), while also providing a substantial recovery for the Debtors' general unsecured creditors. Given the distressed telecom marketplace, this is truly a remarkable achievement.

2. Moreover, assuming the Bidding Procedures Order (as defined in the Motion) is approved, a redlined copy of which is annexed hereto as Exhibit B, the price to be paid for the assets will establish a floor. The Purchase Agreement (as defined in the Motion) also satisfies the Debtors' need to move forward with a transaction with a high likelihood of closure. Once the Bidding Procedures Order is entered, the Purchase Agreement allows the Debtors to conduct an auction that will supplement and confirm that the extensive sale process the Debtors' initiated prior to and after the commencement of these chapter 11 cases truly tested

the marketplace. The Bidding Procedures, establish a process that may obtain even more value for the Debtors' estates than the value provided under the Purchase Agreement with Qwest.

3. The Committee ignores the benefits provided by the Purchase Agreement. By asserting objections to practices and procedures that are not only standard but appropriate, the Committee risks losing the most valuable transaction that is available to the Debtors at this time.

4. Remarkably, the Committee takes such an approach when the Bidding Procedures sought by the Debtors and Qwest are standard procedures found in virtually every complex chapter 11 case that involves the sale of assets. As set forth more fully below, the Break-Up Fee (as defined in the Motion) and the Expense Reimbursement (as defined in the Motion) are well within the accepted practice for transactions of this type. The timetable for the sale process is reasonable and appropriately balances the need to move quickly to avoid deterioration of the value of the business, while at the same time allowing bidders, most of which have already performed due diligence during the Debtors' ongoing sale efforts, to submit Competing Bids (as defined in the Motion).

5. Subsequent to the Committee's filing their Objection, and in the spirit of consensus, the Debtors requested that Qwest modify the Bidding Procedures to accommodate the concerns of the Committee and other objecting parties. Qwest has agreed to modify several aspects of the Bidding Procedures as outlined herein and in the attached Bidding Procedures Order. These modifications represent important concessions on Qwest's part. Those protections that Qwest has not modified are (a) entirely reasonable and prudent, as Greenhill (as defined below) has advised the Debtors and (b) conditions to Qwest's willingness to proceed.

6. This reply is organized as follows: (a) set forth below is the Debtors' response to the Committee's objections to the Break-Up Fee, the Expense Reimbursement and

the bidding deadline and (b) set forth on Exhibit A is the Debtors' response to the remaining objections asserted by the Committee.

The Break-Up Fee and Expense Reimbursement are not Excessive and Should not be Combined

7. The Committee contends that the Break-Up Fee and Expense Reimbursement are excessive. Specifically, the Committee asserts that (a) the proposed Break-Up Fee of $12.8 million is well outside the range of break-up fees usually approved by courts in this and other districts as it constitutes approximately 3.28% of the $390 million Purchase Price and (b) the Expense Reimbursement should be capped at $2 million. The Committee assertion is based on flawed facts and a misstatement of the law in this Circuit.

8. The Debtors' proposed Bidding Procedures were designed to established a platform for a competitive bidding process that would set a floor for the purchase price for the Sale Assets pursuant to a relatively unconditional Purchase Agreement, while at the same time enable potential purchasers to submit a higher and better bid. In that regard, the Bidding Procedures increase the likelihood that the Debtors will receive the highest or best price for the Sale Assets to benefit the Debtors, their estates, their creditors, and all parties in interest. Specifically, the Break-Up Fee fairly compensates Qwest for serving as the stalking horse bidders and the Expense Reimbursement enables Qwest to recover a portion of the expenses it has incurred in conducting due diligence and negotiating the Purchase Agreement.

9. As noted in the Motion, the Purchase Agreement is the result of extensive, hard-fought and highly complex negotiations between Qwest and the Debtors. Throughout the negotiation process, the Debtors consulted with and provided detailed updates regarding the negotiations and their complexity to their prepetition lenders and the Committee. Indeed, the prepetition lenders and the Committee were involved in advising the Debtors on making key

decisions, including whether to enter into the Purchase Agreement with Qwest. As such, the Committee is fully aware that Qwest has expended a significant amount of effort, time and money in negotiating and finalizing the Purchase Agreement to purchase the Sale Assets. Moreover, it is appropriate to compensate Qwest for its efforts and the benefits it has bestowed on the Debtors' estates and reimbursed for its expenses. Notably,

- the Debtors have not paid Qwest for any of its due diligence or negotiation efforts over the past four months at an expense of several millions of dollars;

- Qwest, a major public company, bears a risk for being the stalking horse bidder and, through its tremendous focus on and dedication of resources to this sale transaction, has incurred significant opportunity costs;

- the Break-Up Fee enticed Qwest to satisfy the Debtors' need for an unconditional Purchase Agreement (i.e., the Purchase Agreement does not contain a material adverse change provision);

- the Break-Up Fee and Expense Reimbursement have already substantially benefited the Debtors' estates as Qwest would not have agreed to provide the total consideration for the Sale Assets without these protections;

- the extensive negotiations that led to the Break-Up Fee and the Expense Reimbursement also set a high and meaningful floor for competitive bidding; and

- Qwest as a stalking horse enables the Debtors to commence an auction process and consummate a sale transaction in a reasonable period of time with minimal risk.

10. Bidding protections, such as break-up fees and expense reimbursement, encourage potential purchasers to devote the requisite time, money and efforts to negotiate with a debtor and perform the necessary due diligence, despite the inherent risks and uncertainties of the chapter 11 process and being a stalking horse bidder. See In re 995 Fifth Ave. Assocs., L.P., 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1992) (bidding incentives may "be legitimately necessary to

convince a white knight to enter the bidding by providing some form of compensation for the risks it is undertaking).

11. In the Second Circuit, it is well established that "[a] bankruptcy court should uphold a break-up fee which was not tainted by self-dealing and was the product of arm's length negotiations." Official Comm. of Subordinated Bondholders v. Integrated Resources, Inc. (In re Integrated Resources, Inc.), 147 B.R. 650, 658 (S.D.N.Y. 1992), appeal dismissed, 3 F.3d 49 (2d Cir. 1993). As explained in In re Integrated Resources, when evaluating bid protections, absent self-dealing, bankruptcy courts in the Second Circuit should employ the business judgment rule.[1]

> Generally, a court will assess itself of the merits or fairness of business decisions only "when a transaction is one involving a predominantly interested board with financial interests in the transaction adverse to the corporation." AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986). Moreover, the appropriate test is the "entire fairness" of a transaction, rather than the business judgment rule, only "in the face of illicit manipulation of a board's deliberative processes by self-interested corporate fiduciaries." Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1279 (Del. 1988). A bankruptcy court should uphold a break-up fee which was not tainted by self-dealing and was the product of arm's-length negotiations. See In re 995 Fifth Ave. Assoc., 96 B.R. 24 (Bankr. S.D.N.Y. 1989).
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> The court below found that the discussions between [Debtor] and BT were not tainted by self dealing so as to remove the protection

[1] In objecting to the Motion, the Committee primarily relies on In re S.N.A. Nut Co., 186 B.R. 98 (Bankr. N.D. Ill. 1995) – a bankruptcy court decision outside of the Second Circuit in which the bankruptcy court concluded that the business judgment rule is only applied to decisions made within the ordinary course of business. This holding is in direct contravention of the holdings reached in In re Integrated Resources and Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983), in which the United States Court of Appeals for the Second Circuit held that the business judgment standard applies for sales of assets outside the ordinary course of business pursuant to section 363(b) of the Bankruptcy Code. The S.N.A. court also concluded that the business judgment rule does not apply in the context of a liquidating chapter 11 case. Courts in the Second Circuit disagree. See, e.g., In re Ames Dep 't Stores, Inc., 287 B.R. 112 (Bankr. S.D.N.Y. 2002) (applying business judgment test in context of liquidating chapter 11 case).

> of the business judgment rule. In re Integrated Resources, 135 B.R. at 752. [Appellant] failed to meet its burden of establishing any material personal interest or self-dealing by a majority of [Debtor's] directors. The record does not support appellant's suggestion that management controlled and manipulated the Break-Up fee negotiations.

In re Integrated Resources, 147 B.R. at 658..

12. In applying the business judgment rule to evaluate bid protections, bankruptcy courts in the Second Circuit should consider the following factors: "(i) is the relationship of the parties who negotiated the break-up fee tainted by self-dealing or manipulation; (2) does the fee hamper, rather than encourage, bidding; and (3) is the amount of the fee unreasonable relative to the proposed purchase price." In re Integrated Resources, 147 B.R. at 657.

13. The Committee does not allege "any material personal interest or self-dealing" or that the Break-Up Fee or Expense Reimbursement "hamper[s], rather than encourage[s], bidding." Rather, the Committee asserts that the fee is unreasonable relative to the proposed purchase price. As discussed in the Motion, the Debtors and Qwest agreed on the Break-Up Fee and Expense Reimbursement after lengthy and extensive negotiations. The negotiated Break-Up Fee is approximately (a) 1.5% of the approximate $885 million of total distributable value available for creditors in these chapter 11 cases as a result of the sale transaction (including $300 million of cash, $90 million of notes, $165 of assumed liabilities and $300 million of residual value remaining in the Debtors' estates), (b) 2.3% of the approximate $555 million of total consideration to be received by the Debtors in connection with the sale transaction (excluding the $300 million of residual value) and (c) 3.28% of the cash and note portion of the purchase price. See In re AT&T Latin America Corp., Case No. 03-13538 (BKC-RAM)(Bankr. S.D. Fl.)(4.79% of cash purchase price; 3.23% of cash and assumed liabilities); In

re Genuity, Inc., Case No. 02-43550 (PCB)(Bankr. S.D.N.Y.)(4.13%); In re Fruit of the Loom, Inc., Case No. 99-04497 (PJW)(Bankr. D. Del.)(3.59%).

14. The negotiated Expense Reimbursement (i.e., not to exceed $5 million) is approximately (a) .05% of the approximate $885 million of total distributable value available for creditors in these chapter 11 cases as a result of the sale transaction (including $300 million of cash, $90 million of notes, $165 of assumed liabilities and $300 million of residual value remaining in the Debtors' estates), (b) .09% of the approximate $555 million of total consideration to be received by the Debtors in connection with the sale transaction (excluding the $300 million of residual value) and (c) 1.28% of the cash and note portion of the purchase price (i.e., $390 million). See In re Loral Space & Communications Ltd., Case No. 03-41710 (RDD)(Bankr. S.D.N.Y.)(not to exceed $8 million); In re Conseco, Inc., Case No. 02-B-49672 (CAD)(Bankr. N.D. Ill.)(not to exceed $5 million); In re Comdisco, Inc., Case No. 01-24795 (BWB)(Bankr. N.D. Ill.)(not to exceed $5 million).

15. The Debtors submit that the Break-Up Fee and Expense Reimbursement are reasonable based on the total consideration being provided to the Debtors' estates by Qwest in a transaction of this magnitude and complexity (i.e., a highly complex transaction in a regulated industry). Moreover, the Debtors believe that the Committee's argument that the Break-Up Fee and Expense Reimbursement should be combined is without merit. The Expense Reimbursement is (a) based on actual and documented fees and (b) Qwest has been advised by various professionals, including attorneys and investment bankers (who have been integral in finalizing the negotiations). In addition, it is clear that it is common for courts in this and other jurisdictions to approve the reimbursement of expenses independent of and in addition to the payment of a break-up fee.

The Timing of the Payment of the Break-Up Fee to Qwest is Appropriate

16. The Committee asserts that the Break-Up Fee should only be paid to Qwest if a Competing Bid closes. The justification for this assertion is that break-up fees should only be paid if there is a benefit to a debtor's estate. In response to the Committee's Objection, Qwest agreed that the Break-Up Fee would be payable upon the earlier of (a) the Court approving a Competing Transaction, (b) the Court approving a disclosure statement relating to a plan of reorganization or liquidation that does not contemplate a sale of the Sale Assets to Qwest or (c) the date of any Second Highest Bidder Election (as defined in the mark-up of the Bidding Procedures Order, which is annexed hereto as Exhibit A), unless the Second Highest Bidder Election is due to a breach of the Buyer.

17. Under the terms of the Bidding Procedures Order (as modified), the Break-Up Fee is paid only if the Debtors determine to proceed with an alternative transaction. To proceed with such a transaction, by definition, the Debtors, after consulting with, among others, the Committee, would need to determine that it was more valuable to the estates than the sale of the Sale Assets to Qwest. Accordingly, the Debtors' estates would have benefited significantly by Qwest agreeing to be the stalking horse bidder. As such, it is entirely appropriate to pay the Break-Up Fee to Qwest in accordance with the terms of the Bidding Procedures Order (as modified). See In re Trans World Airlines, Inc., Case No. 01-0056 (SLR).

The 30-Day Period is Appropriate and in the Best Interests of the Debtors' Estates

18. The Committee argues that the 30-day period between the Bidding Procedures Hearing and the Bid Deadline is not sufficient to allow Potential Bidders to conduct the necessary due diligence to submit a Qualified Bid. As a result, the Committee asks that the period for soliciting bids be extended to at least 65 days. The 30-day period for soliciting bids was the product of extensive arm's-length negotiations, was a critical condition for Qwest to

enter into the Purchase Agreement and, under the facts and circumstances of these chapter 11 cases and the Debtors' sale process, is entirely appropriate and prudent.

19. The Debtors submit that 30 days is sufficient for enabling potential bidders to conduct due diligence and submit Qualifying Bids. In that regard, Greenhill & Co. ("Greenhill"), the Debtors' experienced financial advisors, advised the Debtors that, in the context of the sale of the Sale Assets, 30 days will provide sufficient time for potential bidders to conduct due diligence and submit a Qualified Bid. Specifically,

- Greenhill, on behalf of the Debtors, prepared and widely circulated a confidential information memorandum regarding the Debtors assets to potential bidders in March 2003;

- The Debtors commenced their chapter 11 cases on May 14, 2003, and it has been well known that the Debtors' assets were on the market;

- Since the Commencement Date (as defined in the Motion), several potential strategic buyers and financial players have signed confidentiality agreements, conducted due diligence, and actively considered the acquisition of the Debtors' assets;

- The prospective sale of the Sale Assets to Qwest is itself the product of a competitive process, has been highly publicized and has clearly been well-known to the sophisticated parties who are potential bidders for the Sale Assets; and

- The Debtors have established an electronic data room, and Greenhill has advised the Debtors that it has a process in place that will enable any interested party to conduct diligence and submit a bid within 30 days.

20. In addition to the 30-day time period being sufficient and reasonable, a longer time period places a significant risk, if not a likelihood, that the value of the Sale Assets will diminish if the sale is delayed. Evidencing the Debtors' deteriorating financial condition, the Debtors' sales of customer lines—a critical metric for the value of these assets—has dropped significantly. Indeed, in November 2003, the Debtors gross addition of new customers fell 20%

below their planned number. That dramatic shortfall reflects a loss of confidence by the Debtors' customers in the viability of their business operations. Moreover, one of the potential bidders, Corvis Corporation, filed an objection to the Motion, which provided, in pertinent part, that a delay in the sale process could have an adverse impact on the value of the Debtors' assets. Under these circumstances, and as Greenhill has advised the Debtors, the 30 day time period is entirely appropriate, and the prudent way to preserve the value of the estates for all of its constituents—including its creditors, customers, and employees.

CONCLUSION

For all of the foregoing reasons, the Debtors' Motion should be granted.

Dated: New York, New York
January 9, 2004

Respectfully submitted,

/s/ Matthew A. Cantor

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