

KIRKLAND & ELLIS LLP
Citigroup Center
153 East 53rd 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

In re	:	X
	:	
Allegiance Telecom, Inc., <u>et al.</u> ,	:	Chapter 11 Case No.
	:	03-13057 (RDD)
	:	
Debtors.	:	Jointly Administered

**DEBTORS' OBJECTION TO PROVISIONAL MOTION OF
WORLDCom, INC. AND ITS DEBTOR AFFILIATES FOR RELIEF FROM
THE AUTOMATIC STAY WITH RESPECT TO CERTAIN LETTER OF CREDIT**

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

Allegiance Telecom, Inc. and its direct and indirect subsidiaries, as debtors and debtors in possession (collectively, the "Debtors"), hereby object to the Provisional Motion of WorldCom, Inc. and Its Debtor Affiliates ("WorldCom") for Relief From the Automatic Stay With Respect to Certain Letter of Credit (the "Lift Stay Motion"), respectfully represent:

Background

1. *On July 21, 2002 and November 8, 2002*, WorldCom commenced cases under chapter 11 of title 11 of Bankruptcy Code in the Bankruptcy Court for the Southern District of New York, Case No. 02-13533 (AJG) (the "WorldCom Bankruptcy"). WorldCom continues to operate its businesses and manage its properties as debtors in possession.

2. After the commencement of the WorldCom Bankruptcy, the Debtors and WorldCom alleged claims and disputes against each other that arose from, among other things, various agreements between the parties. In that regard, *on or about December 9, 2002*, WorldCom placed the Debtors on credit hold (the “Credit Hold”) and refused to provide additional services to the Debtors until the Debtors provided additional security to WorldCom.

3. In order to reach a resolution and be removed from Credit Hold, the Debtors and WorldCom entered into that certain Agreement for Additional Services, Security, and Settlement of Certain Matters, as amended by Addendum No. 1 thereto, dated *April 15, 2003* (the “Settlement Agreement”).

4. On *May 2, 2003*, WorldCom filed a motion (the “WorldCom 9019 Motion”), pursuant to Bankruptcy Rule 9019, seeking approval of the Settlement Agreement (i.e., twelve (12) days before the Commencement Date (as defined herein)).

5. On *May 14, 2003* (the “Commencement Date”), the Debtors commenced cases under chapter 11 of title 11 of the Bankruptcy Code. The Debtors’ chapter 11 cases have been consolidated for procedural purposes only and are being jointly administered. The Debtors continue to operate their businesses and manage their properties as debtors in possession pursuant to section 1107(a) and 1108 of the Bankruptcy Code.

6. On *May 28, 2003*, the United States Trustee for the Southern District of New York appointed the statutory committee of unsecured creditors (the “Creditors’ Committee”).

7. On *May 29, 2003* (i.e., fifteen (15) days *after* the Commencement Date), the Court in the WorldCom Bankruptcy entered an order approving the WorldCom 9019 Motion, a copy of the order is annexed hereto as Exhibit A.

The Settlement Agreement

8. Pursuant to the Settlement Agreement,¹ which was subject to bankruptcy court approval in the WorldCom Bankruptcy:

- The Debtors and WorldCom waived all claims against each other that arose prior to July 21, 2002;
- The Debtors and WorldCom settled all claims against each other that arose after July 21, 2002 and through and including February 28, 2003 and all undisputed outstanding balances due and payable by each party to the other party after July 21, 2002 and through and including March 31, 2003;
- Allegiance Telecom Company Worldwide (“ATCW”), one of the Debtors, caused JP Morgan Chase Bank (“JP Morgan”) to issue an irrevocable letter of credit (the “LOC”) in the amount of \$3 million for the sole benefit of WorldCom;
- ATCW and WorldCom agreed that WorldCom would have the right to draw against the LOC to receive amounts equal to unpaid undisputed charges for the services provided by WorldCom if, and only if, (a) the Debtors received invoices from WorldCom, which included such undisputed amounts, (b) the Debtors failed to pay such undisputed amounts within sixty (60) days after the receipt of such invoices and (c) if the Debtors failed to pay the undisputed amounts in the invoices, WorldCom, upon fifteen (15) days prior written notice to the Debtors of WorldCom’s intention to draw on the LOC, could provide JP Morgan with a sight draft; and
- ATCW made certain payments to WorldCom.

9. Notably, in order to obtain the LOC, ATCW was required by JP Morgan (the “Issuer”) to pledge (i.e., transfer) a certificate of deposit in the amount of \$3,000,000 (the “CD”) as security for the issuance of the LOC. The issuance of the LOC occurred on April 28,

¹ The Settlement Agreement contains confidential proprietary and commercial information and includes a provision requiring both WorldCom and the Debtors to maintain the confidentiality of the terms set forth therein. WorldCom, in its Lift Stay Motion, disclosed the provisions relating to whether it had the right to draw against the LOC (as defined below). In that regard, this Objection also discusses that provision. The Debtors reserve their right to seek authorization from the Court, in the event that it is necessary, to file the Settlement Agreement under seal. The Debtors further request that the Court conduct, if necessary, an in camera hearing on the Settlement Agreement with only representatives from the Debtors and WorldCom, the U.S. Trustee, and the attorneys and professionals for the Creditors Committee and the Debtors’ Prepetition Lenders in attendance.

2003 (i.e., 13 days after the effectiveness of the Settlement Agreement and *only* 16 days before the Commencement Date).

Section 1.a.ii of the Settlement Agreement

10. As noted above, WorldCom, in the Lift Stay Motion, seeks approval to draw under the LOC (either by the Court acknowledging that Court approval is unnecessary or entering an order modifying the automatic stay). *Accordingly, the critical issue is whether WorldCom has the right to draw against the LOC.* The operative document is the Settlement Agreement, which is a prepetition executory contract, see, e.g., Shoppers World Cmty. Ctr., L.P. v. Bradlees Stores, Inc. (In re Bradlees Stores, Inc.), No. 01 Civ. 3934 (SAS), 2001 WL 1112308 (S.D.N.Y. Sept. 20, 2001), and the operative provision is section 1.a.ii. of the Settlement Agreement. Section 1.a.ii. of the Settlement Agreement provides:

Upon fifteen (15) days prior written notice to Allegiance specifying the amounts requested to be drawn from the LOC in sufficient detail so as to put Allegiance on notice as to the amounts being drawn against the LOC and what undisputed amounts owed by Allegiance are being satisfied by such draw, the LOC *may* be drawn upon by WorldCom and the Issuer shall, upon presentation by WorldCom to the Issuer of a sight draft in the amount of the unpaid undisputed charges, honor the draft and pay to WorldCom the draft amount *if Allegiance fails to pay any such WorldCom undisputed charges for any Services provided by WorldCom for sixty days from the receipt of the invoice by Allegiance.*

WorldCom Violated the Automatic Stay and the Settlement Agreement is Without Effect

11. Pursuant to section 362(a)(1) of the Bankruptcy Code, the commencement of a chapter 11 case operates to stay the “continuation ... of a judicial, administrative, or other action or proceeding against the debtor that was ... commenced before the commencement of the [bankruptcy proceeding].” 11 U.S.C. § 362(a)(1). “The stay is automatic and mandatory with the filing of a petition and therefore a motion for a stay need not be made in this court or the

bankruptcy court.” Commerzanstalt v. Telewide Sys., Inc., 790 F.2d 206, 207 (2d Cir. 1986). “Since the purpose of the [automatic] stay is to protect creditors as well as the debtor, the debtor may not waive the automatic stay.” Id. It is black letter law in the Second Circuit that an action taken in violation of the automatic stay is void *ab initio* and without effect. See 48th Street Steakhouse, Inc. v. Rockefeller Group, Inc. (In re 48th Street Steakhouse, Inc.), 835 F.2d 427, 430 (2d Cir. 1987); In re Cenargo Int’l, PLC, 294 B.R. 571, 597 (Bankr. S.D.N.Y. 2003)(“actions taken in violation of the automatic stay are void *ab initio*).

12. As noted above, WorldCom filed the WorldCom 9019 Motion on *May 2, 2003*. On *May 14, 2003*, prior to the WorldCom 9019 Motion being approved in the WorldCom Bankruptcy Cases, the Debtors commenced their chapter 11 cases, thereby invoking the automatic stay. It is axiomatic that the automatic stay precluded any party, including WorldCom, from continuing a judicial action, which includes the prosecution of the WorldCom 9019 Motion, against the Debtors to recover a prepetition claim. See, e.g., Commerzanstalt, 790 F.2d at 207 (holding that an appeal is indisputably a continuation of a judicial action or proceeding and, therefore, automatically stayed). Notwithstanding this axiom, WorldCom continued to seek court approval of the WorldCom 9019 Motion, which, if approved, would require the Debtors to make payments to WorldCom on account of prepetition claims and to cause the issuance of an LOC to protect WorldCom, subject to certain conditions, in respect of the payment of certain undisputed prepetition amounts. On *May 29, 2003*, an order was entered in the WorldCom Bankruptcy approving the WorldCom 9019 Motion. Thereafter, (a) WorldCom sought and accepted payment from the Debtors pursuant to the Settlement Agreement and (b) certain terms and conditions under the Settlement Agreement, including those relating to the LOC, became effective.

13. The (a) continued prosecution by WorldCom of the WorldCom 9019 Motion, (b) entry of the order approving the WorldCom 9019 Motion and (c) request for and acceptance of the payments made by the Debtors to WorldCom under the Settlement Agreement were clear violations of the automatic stay. As a result, the Settlement Agreement and its terms and conditions, including WorldCom's asserted right to draw against the LOC, are void *ab initio*.²

WorldCom is Precluded from Drawing Against the LOC

14. To the extent the Court determines that (a) WorldCom did not violate the automatic stay and, therefore, (b) the Settlement Agreement is in effect, the Debtors submit that WorldCom is precluded from drawing against the LOC. When a debtor commences a chapter 11 case, all efforts to collect on prepetition claims are precluded by the automatic stay. 11 U.S.C. § 362(a). The automatic stay applies to any effort "to recover a claim against the debtor that arose before the commencement of the case" or "exercise control over property of the debtor's estate." 11 U.S.C. § 362(a)(1) and (3). As a result, the automatic stay, "freezes the rights of creditors as of the date of the filing of a petition under the Bankruptcy Code in order to protect against the piecemeal distribution of the bankruptcy estate." In re Elsinore Shore Associates, 66 B.R. 723, 731 (Bankr. D.N.J. 1986).

15. An executory contract is property of a debtor's estate. 11 U.S.C. § 541(a). "From the moment of filing to the moment of assumption or rejection [of a contract], the non-debtor party [to such contract] is held to be barred from enforcing the contract and its terms." In re El Paso Refinery, L.P., 220 B.R. 37, 43 (Bankr. W.D. Tex. 1998). Until the debtor determines

² The Debtors reserve their right to (a) seek, pursuant to section 549 of the Bankruptcy Code or otherwise, the return of the payments made to WorldCom under the Settlement Agreement, (b) revoke the LOC issued pursuant to the Settlement Agreement and (c) take any other action that is appropriate and necessary in connection with WorldCom's violation of the automatic stay.

whether to assume or reject a contract, “the status of the non-debtor party’s claims against the estate is held in *statis*, pending the estate’s decision.” *Id.*

16. In the Lift Stay Motion, WorldCom³ asserts – and the Debtors agree – that letters of credit and the proceeds therefrom are not property of a debtor’s estate. *That, however, is not relevant to this dispute.* What is relevant is *whether WorldCom has the right to draw under the LOC.* The agreement governing this issue is the Settlement Agreement, which is property of the Debtors’ chapter 11 estates and, therefore, subject to the jurisdiction of the Court. The Settlement Agreement is specific on when and under what circumstances WorldCom may draw under the LOC. In that regard, the following must occur:

- (a) the Debtors must receive an invoice from WorldCom, which includes undisputed amounts,
- (b) the Debtors have sixty (60) days from receipt of the invoice to pay any undisputed amounts, and
- (c) if the Debtors fail to pay the undisputed amounts within the sixty (60) day period, WorldCom may draw against the LOC, if it has provided the Debtors with fifteen (15) days express written notice of, among other things, the amount of the undisputed amounts to be paid from the LOC (the “15 Day Notice Period”).⁴

Only one of these events occurred and, therefore, WorldCom may not draw against the LOC.

17. Beginning on April 1, 2003 and continuing to the Commencement Date, the Debtors received various invoices from WorldCom. As a result, and assuming that undisputed amounts were reflected in the invoices, the Debtors, in accordance with the Settlement Agreement, had sixty (60) days from the date of the receipt of the invoices to pay such undisputed amounts. Prior to end of the sixty (60) day period, the Debtors commenced

³ Notably, WorldCom is an unsecured creditor. See In Dairy Mart Convenience Stores, Inc., 351 F.3d 86, 91 (2nd Cir. 2003) (A letter of credit does not create a security interest in the assets of the debtor).

these chapter 11 cases. As a result of the commencement of these chapter 11 cases and pursuant to section 362(a) of the Bankruptcy Code, (a) WorldCom was precluded from seeking (i) payment from the Debtors for any amounts reflected in the invoices – i.e., such amounts are prepetition claims – or (ii) to compel the Debtors to comply with the Settlement Agreement and (b) the Debtors were precluded from paying the undisputed amounts – i.e., to do otherwise would be a degradation of the provisions of the Bankruptcy Code. Accordingly, as of the Commencement Date, the rights of WorldCom under the Settlement Agreement were “rendered temporarily unenforceable. . . ,” In re El Paso Refinery, L.P., 220 B.R. 37, 43 (W.D. Tex. 1998), and, thus, the sixty (60) day period did not run. Based on the foregoing, the Debtors submit that WorldCom does not have the right to draw against the LOC.

**Assuming that WorldCom had the Right to Draw
Against the LOC, the Lift Stay Motion Should Be Denied⁵**

18. Assuming that the Court determines that the conditions necessary to permit WorldCom to draw against the LOC have been met, the Lift Stay Motion should still be denied. Although neither a letter of credit nor its proceeds are property of the debtor’s estate, collateral that has been pledged by a debtor as security for a letter of credit is property of the debtor’s estate. See In re Air Conditioning of Stuart, 845 F.2d 293, 296 (11th Cir. 1988), cert. denied sub nom., First Interstate Credit Alliance v. American Bank of Martin County, 488 U.S. 993 (1988); accord In re Compton Corp., 831 F.2d 586, 590-591 (5th Cir.1987). “When a debtor

⁴ Despite WorldCom’s contention that the Lift Stay Motion should constitute notice of the 15 Day Notice Period, the Debtors reserve their right, if necessary and appropriate, to assert that such notice may violate the automatic stay.

⁵ As the Court is aware, the Debtors are in the process of selling a substantial portion of their assets to Qwest Communications International Inc., or a higher or better bidder to be determined at an auction currently scheduled for February 12, 2004. In connection with the sale of these assets, it may be determined whether the Settlement Agreement will be assumed. If the Settlement Agreement is assumed, WorldCom’s prepetition claims thereunder will be cured. Thus, the resolution of the issue may be premature as it may be resolved through the sale process in the near future.

pledges its assets to secure a letter of credit, a transfer of debtor's property has occurred under the provisions of [section 547 of the Bankruptcy Code]." In re Compton Corp., 831 F.2d at 594.

19. Even where the direct transfer to the third party may be valid and not subject to challenge pursuant to section 547(b) of the Bankruptcy Code, "the indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefited from the direct transfer to the third party." Id. at 591-592. To the extent it is determined that property was transferred in violation of section 547(b) of the Bankruptcy Code, a debtor in possession may recover the value of such transfer from "the initial transferee of such transfer *or the entity for whose benefit such transfer was made*" 11 U.S.C. § 550(a)(1)(emphasis supplied).

20. If a transfer of property may be avoidable as preference under section 547(b) of the Bankruptcy Code, the court should deny a motion to lift the automatic stay to allow a non-debtor party from drawing against a letter of credit to allow the debtor in possession to pursue a preference action against such party. See, e.g., In re National Quick Print, Inc., 103 B.R. 107, 110 (Bankr. D. Md. 1989); In re Kroh Bros. Development Co., 86 B.R. 186, 192 (Bankr. W.D. Mo. 1988).

21. The Debtors believe that the pledge of the CD to JP Morgan, which secured the LOC, may be avoidable under section 547(b) of the Bankruptcy Code and the value of such CD may be recoverable from WorldCom under section 550(a) of the Bankruptcy Code. In that regard, the pledge of the CD was a transfer of an interest of the Debtors in property (a) for the benefit of WorldCom, (b) on account of an antecedent debt owed by the Debtors before the transfer was made,⁶ (c) made while the Debtors were insolvent, (d) made within ninety (90) days

⁶ The Debtors believe that at least certain, if not substantially all, of the services provided by WorldCom to the Debtors that were invoiced and "undisputed" arose prior to the pledge of the CD.

of the Commencement Date and (e) may enable WorldCom to receive more than it would receive if the Debtors' chapter 11 cases were chapter 7 cases. Accordingly, the Debtors submit that the Lift-Stay Motion should be denied to allow the Debtors to complete their analysis and pursue a preference action, if necessary.⁷

22. WHEREFORE, the Debtors respectfully request that (a) the Court deny the relief sought in the Lift Stay Motion and (b) grant the Debtors such other and further relief as is just.

Dated: New York, New York
February 2, 2004

Respectfully submitted,

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

Attorneys for Debtors and Debtors in Possession

⁷ The Debtors have not completed their analysis of the issue of whether the pledge of the CD is avoidable under section 547(b) of the Bankruptcy Code. Prior to filing an adversary proceeding, the Debtors would need to complete this analysis and, potentially, conduct discovery.