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Hearing Date: March 18, 2004  
at 10:00 a.m.

— and —

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UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK

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In re :  
ALLEGIANCE TELECOM, INC., et al., : Chapter 11  
Debtors. : Case No. 03-13057 (RDD)  
: (Jointly Administered)  
: :  
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**MOTION, FILED UNDER SEAL, IN PART, OF LEVEL 3  
COMMUNICATIONS, LLC SEEKING AN ORDER PERMITTING  
RECOUPMENT AND RELIEF FROM THE AUTOMATIC  
STAY, AS MAY BE NECESSARY: (i) TO PERMIT RECOUPMENT  
AND/OR SETOFF OF CERTAIN CLAIMS; (ii) TO REQUIRE  
THE PARTIES TO PROCEED WITH THE DISPUTE  
RESOLUTION PROCESS SET FORTH IN THE PARTIES'  
AGREEMENT; AND (iii) FOR CERTAIN OTHER ANCILLARY RELIEF**

Level 3 Communications, LLC (“Level 3”), by and through its undersigned  
counsel, pursuant to §§105, 361, 362(d), 363(e), 507(b) and 553 of Title 11 of the United States  
Code, 11 U.S.C. §101 et seq. (the “Bankruptcy Code”), files this motion (the “Motion”), having

notified Debtor, Allegiance Telecom Company Worldwide (“Allegiance”) that it is exercising its rights of credit and recoupment, pursuant to the terms of the INSPA (as defined herein), in respect of the February Payment (as defined below):

### SUMMARY OF MOTION

1. For a substantial period of time, and continuing to date, Allegiance has failed to meet certain requisite levels of performance set forth in that certain Integrated Network Solution Purchase Agreement, originally dated July 24, 2000 (as amended, the “INSPA”). The INSPA contains various formulae for credits in the event Allegiance’s performance is deficient.

2. Pursuant to the terms of the INSPA, Level 3 has an absolute right to credit and recoup its damage claim against future payments due to Allegiance. Despite its contractual right, Level 3 has cooperated with Allegiance in this reorganization proceeding and has entered into stipulations pursuant to which it has made the quarterly payments due to Allegiance under the INSPA, without recoupment, but without prejudice to its rights to recoup at a later date. Since the filing of the bankruptcy cases, Level 3 has paid Allegiance the aggregate sum of nearly \$50 million under this arrangement.

3. Allegiance’s substandard performance under the INSPA continues unabated and, in some respects, worsened in the last few months of 2003. Particularly, in light of the present posture of these cases, it is predictable and likely that Allegiance’s already poor performance under the INSPA will further deteriorate.

4. Accordingly, at this point, in order to protect its own business and a key customer, Level 3 must exercise its contractual rights under the INSPA by recouping its Performance Warranty Claims (as defined below) against the payment of \$25 million due to Allegiance on or about February 4, 2004 (the “February Payment”).

5. Further, the INSPA contains specific "Dispute Resolution Procedures" in the event of a dispute concerning Level 3's recoupment of its credits. The Dispute Resolution Procedures involve, among other things, meetings of employees and officers with technical expertise and a good faith mediation process. In the event, as anticipated, Allegiance disputes Level 3's right of recoupment, Level 3 requests that the parties proceed to an expeditious resolution of their dispute in accordance with the procedures set forth in the INSPA.

### **BACKGROUND**

6. On May 14, 2003 (the "Filing Date"), each of the Debtors filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Since that day, the Debtors have continued to operate as debtors in possession. On May 28, 2003, an official committee of unsecured creditors was appointed in the Debtors' Chapter 11 cases.

7. Level 3 is one of the world's largest fiber optic network and communications support service providers and is, *inter alia*, in the business of providing dial-up modem services, as well as other business services to major corporate customers.

8. On July 24, 2000, Genuity Solutions, Inc. ("Genuity"), and Allegiance entered into the INSPA. The amendments are identified as follows: (i) Amendment One to the INSPA between Genuity and Allegiance, dated September 29, 2000; (ii) Amendment Two to the INSPA between Genuity and Allegiance, dated December 29, 2000; (iii) Amendment Three to the INSPA between Genuity and Allegiance, dated December 31, 2001, and (iv) Amendment Four to the INSPA between Genuity and Allegiance, dated August 21, 2002 ("Amendment Four"). An unredacted copy of the INSPA is attached hereto as Exhibit "A."<sup>1</sup>

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<sup>1</sup> This Motion's Exhibits have been or will be filed under seal because the INSPA and its terms contain information which is confidential and proprietary to both Allegiance and Level 3.

9. Pursuant to the INSPA, Allegiance provides an integrated network solution for Level 3's dial-up modem services business. The INSPA was acquired and assigned to Level 3 by Genuity in the context of Genuity's own Chapter 11 bankruptcy cases pending before this Court, In re Genuity Solutions, Inc., et al., Bankruptcy Case No. 02-43550 (Bankr. S.D.N.Y.) pursuant to an Order of this Court, dated January 24, 2003.

10. Pursuant to the INSPA, Level 3 agreed to make payments to Allegiance over the term of the INSPA called "Purchase Price Payments" (INSPA at §3.1(a)) in accordance with a schedule at Attachment B to Amendment Four (see Exhibit "A"), and subject to the payment, invoice and notice requirements of the INSPA. (INSPA § 3.2). Pursuant to the INSPA, on a quarterly basis through August 2006, Level 3 may owe Allegiance a Purchase Price payment in the maximum amount of \$25 million. (INSPA, Amendment 4, Attachment B). In December 2006, Level 3 may owe Allegiance a final payment of \$8,010,886.00. *Id.*

11. The INSPA expressly provided for credits against the payments in the event there were deficiencies in service. Deficiencies include, inter alia, the inability of a customer to connect his call due to busy signals or other failures.

12. Pursuant to §2.6 of the INSPA, "if Allegiance fails to provide the Integrated Network Solution in accordance with the Performance Warranties, Genuity, at its election, may receive the applicable remedies set forth in Schedule 2.6(a) (the "Performance Warranty Remedies"), and will offset such charges against the amount owed to Allegiance by Genuity for the next payment of the purchase price in accordance with §3.2(c)." (INSPA, §2.6(a)). Similarly, Section 3.2(c) of the INSPA provides that Level 3 "may offset Purchase Price Payments by amounts payable to [Level 3] by Allegiance in accordance with Sections . . . 2.6(a) . . ."

13. Pursuant to Schedule 2.6(a) to the INSPA in connection with "Call Blocking Events" (as that term is defined in the INSPA), absent Allegiance's remedy within a twenty-four hour period, then "for the Ports<sup>2</sup> with respect to which the Call Blocking Events occurred, Genuity shall offset against the next Purchase Price Payment an amount equal to the number of Ports for (i) the entire month in which the unavailability occurs multiplied by twenty dollars (\$20.00); and (ii) two (2) additional months thereafter." (INSPA, Schedule 2.6(a) at 66).

14. Further, Allegiance claimed *force majeure* to justify its failure to install 1,392 Ports in the Iowa, Wisconsin, and Missouri marketplace through September, 2003. It then, by letter, withdrew its claim to such defense. Allegiance, however, has not, to date, delivered the required Ports. Pursuant to §2.4(a) of the INSPA, *inter alia*, Level 3 "shall offset against the next Purchase Price Payment an amount equal to the number of Ports multiplied by twenty dollars (\$20.00) for each month" after the first and second months of delivery failure.

15. Pursuant to correspondence dated May 1, 2003, between Level 3 and Allegiance, which is attached hereto as Exhibit "B," Allegiance agreed that Level 3's rights, remedies, and claims under the INSPA for "Call Blocking Event" warranty breach, including, without limitation, future offset rights (such as certain of the recoupment rights that are the subject of this Motion), were reserved in full.

16. When the August 2003 quarterly payment under the INSPA became due, Level 3 and Allegiance entered into a stipulation (the "September Stipulation") pursuant to which, *inter alia*, Level 3 reserved its rights to seek recoupment of all its claims against future quarterly payments. Three months later, when the next payment became due, Level 3 and

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<sup>2</sup> The INSPA defines "Port" as "...an individual data channel in [Level 3's network] and all connections thereto, and to be deployed in [Level 3's network] regardless of the physical product that houses such data channel in accordance with Configuration Plan, and includes the NAS, PRI, IMT's, Ethernet Switches, terminal concentration and POP router." See INSPA, Schedule A.

Allegiance entered into a further stipulation (the "November Stipulation") reserving all rights with respect to its claims. Copies of the September Stipulation and the November Stipulation, which were approved by the Court, are annexed as Exhibit C.

17. After Allegiance obtained a Bar Date Order requiring the filings of proofs of claim by November 26, 2003, Level 3 timely filed its proof of claim (the "Proof of Claim") with respect to its Performance Warranty Claims under the INSPA. A copy of the Proof of Claim, is annexed as Exhibit D.

18. On January 5, 2004, Level 3 received an invoice, dated January 2, 2004, from Allegiance, requiring the payment of \$25,000,000 on or before February 4, 2004 (the "February Payment"). A copy of the invoice is annexed as Exhibit E.

19. Level 3 is not prepared, as it has been in the past, to pay the invoice without recoupment of its Performance Warranty and delivery Claims. Accordingly, by Notice dated February 4, 2004, a copy of which is annexed as Exhibit F, Level 3 notified Allegiance that it was exercising its recoupment rights against the February Payment with respect to its Performance Warranty Claims. As set forth in the Notice, and the detailed schedule annexed thereto, pursuant to conservative metrics for the period from January 16, 2003, through January 15, 2004, the calculation of the recoupment is as follows:

- (i) Credit for Call Blocking Events -- \$26,050,142;
- (ii) Credit for Backhaul Latency -- \$5,040; and
- (iii) Credit for delivery claims including the failure to deliver Ports, whether due to "Force Majeure" events or not -- \$83,520.

(the above credits are collectively referred to as the "Performance Warranty Claims")

20. Thus, the total recoupment against the February Payment is \$26,138,702. To the extent that the recoupment is in excess of the \$25,000,000 February Payment, Level 3 reserves such recoupment rights against future invoices.

21. In its February 4, 2004 Notice, Level 3 proposed to deposit \$25,000,000 with the Court or in escrow pending resolution of any dispute concerning its recoupment rights.

### **NOTICE AND ALTERNATIVE RELIEF REQUESTED**

#### **I. Level 3 is Effectuating Recoupment of its Performance Warranty Claims Against the February Payment.**

22. As described above, Level 3's right to recoupment for the Performance Warranty Claims against the quarterly payments are specifically set forth in Section 2.6(a) and Section 3.2(c) of the INSPA. As set forth in the accompanying Memorandum of Law, this absolute right of recoupment does not require prior court approval or any motion to be relieved from the automatic stay. Nonetheless, by this motion, Level 3 seeks to advise the Court of the exercise of its contractual right and its intention to move forward with the dispute resolution procedures set forth in the INSPA.

23. Alternatively, although Level 3 asserts that the exercise of its contractual rights against the February Payment is in the nature of recoupment, rather than a setoff, which setoff may be otherwise stayed pursuant to Bankruptcy Code §362(a), in the event that this Court considers such credit to be a setoff, and that such setoff is stayed, Level 3 should be granted relief from the automatic stay in order to credit the payment of the Performance Warranty Claims against the February Payment pursuant to Bankruptcy Code §362(d)(1), in light of: (i) the existence of Performance Warranty Claims and the continued occurrence and/or subsistence of the same post-petition; (ii) Allegiance's continued substandard performance under the INSPA;

and (iii) the likelihood that Allegiance performance under the INSPA will worsen after closing on the Qwest or an alternate topping transaction.

**II. Level 3 is Prepared to Move Forward  
with the INSPA's Dispute Resolution Process**

24. Level 3 is prepared to proceed immediately with the Dispute Resolution Procedures set forth in Schedule 13.1 of the INSPA. Level 3 recognizes, based upon prior correspondence between the parties and other interactions, that Allegiance will challenge the recoupment referred to herein.

25. Pursuant to Section 3.4 of the INSPA, a dispute concerning a credit taken by the other party must be resolved by the Dispute Resolution Procedures. Pending resolution of a bona fide dispute, the failure to pay cannot be considered a basis for a default under the Agreement. The Dispute Resolution Procedures require the party against whom the dispute is resolved to pay all fees reasonably incurred relating to the dispute, and any amounts that may later be proved to be due and owing must be promptly paid in accordance with the resolution. Section 3.4 states as follows:

**Disputed Charges.** If either Party disputes the accuracy or applicability of a charge or credit or other financial arrangement described in this Agreement, such Party will notify the other Party of such dispute as soon as possible. The Parties will investigate and resolve the dispute using the dispute resolution processes provided under Section 13.1. Upon resolution of the dispute, the Party owing any amounts related thereto will promptly pay the disputed amounts payable in accordance with such resolution. The Party against whom the dispute is resolved will pay all fees reasonably incurred related to the dispute. Unpaid and uncredited monies that are subject to a bona fide dispute will not be considered a basis for monetary default under this Agreement.

26. The Dispute Resolution Procedures, set forth in Section 13.1 and Schedule 13.1 of the INSPA, provide for each party to initially appoint a designated representative to endeavor to resolve the dispute by the exchange of information and negotiation



in good faith. In the event that the dispute is not resolved within 30 days of a request to appoint a designated representative, the dispute will be escalated to an officer of Level 3 and Allegiance for their review and resolution. Thereafter, if the dispute is not resolved within 90 days, the parties will mediate their dispute under the commercial mediation rules of the American Arbitration Association. The Dispute Resolution Procedures do permit a party to resort to court action for injunctive relief if the dispute resolution processes would permit or cause irreparable injury due to delay arising out of the process.

27. Level 3 is prepared to proceed expeditiously with the Dispute Resolution Procedures. In the event Allegiance disputes the recoupment, Level 3 hereby nominates John Ryan, a Level 3 Vice President and Assistant General Counsel, as its designated representative for dispute resolution purposes. Level 3 believes that due to the highly technical aspects involving matters relating to Call Blocking Events and Backhaul Latency events, which are the primary bases for the recoupment, this matter should proceed to the dispute resolution process. Such process will involve individuals with the technical expertise necessary to resolve the dispute. Level 3 does not believe that it is necessary to move for relief from the automatic stay in order to proceed with the contractual dispute resolution process, especially since the mediation process is non-binding, but in the exercise of caution, seeks relief under Bankruptcy Code § 362(d)(1), as the same may be applicable, so that the Dispute Resolution Procedures can commence.

### **III. Rights Reservation**

28. Level 3 hereby reserves all of its claims against the Debtors, including, without limitation, setoff, recoupment, offset, hold and freeze claims, whether exercisable in the ordinary course of Level 3's business or otherwise, in respect of the INSPA, other documents,

agreements, instruments and tariffs between or in respect of Level 3, the Debtors, and affiliates of the Debtors.

**NO PRIOR MOTION**

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

**WHEREFORE**, as may be necessary, pursuant to Bankruptcy Code §§105(a), 361, 362(d), 363(e), 507(b), and 553, Level 3 respectfully requests that this Court enter an Order: (i) authorizing Level 3 to credit the Performance Warranty Claims against the February Payment pending resolution of the dispute; (ii) directing Level 3 and Allegiance to proceed with the Dispute Resolution Procedures set forth in the INSPA; and (iii) granting Level 3 such other and further relief as this Court may deem just and appropriate.

Dated: February 4, 2004

**BLANK ROME LLP**

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