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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF TEXAS
(DALLAS DIVISION)

In re:	)	Chapter 11
	)	
VARTEC TELECOM, INC., et al.,	)	Case No. 04-81694-saf11
	)	
Debtors.	)	Jointly Administered
	)	

RESPONSE OF THE OPERATING TELEPHONE COMPANY SUBSIDIARIES OF VERIZON COMMUNICATIONS INC. TO DEBTORS' FIRST AMENDED MOTION TO DETERMINE THE VERIZON ENTITIES' ABILITY TO EFFECTUATE SETOFF

The operating telephone company subsidiaries of Verizon Communications Inc. (such subsidiaries, collectively, "Verizon")[1] hereby respond to the *First Amended Motion To Determine The Verizon Entities' Ability To Effectuate Setoff* (the "Motion") filed by the above-referenced debtors in possession (the "Debtors"). In support thereof, Verizon respectfully represents as follows:

INTRODUCTION

[1] The operating telephone company subsidiaries of Verizon Communications Inc. are Verizon North Inc., Contel of the South, Inc., Verizon South Inc., Verizon Northwest Inc., GTE Midwest Incorporated d/b/a Verizon Midwest, GTE Southwest Inc. d/b/a Verizon Southwest, Verizon California Inc., Verizon Delaware Inc., Verizon Florida Inc., Verizon Hawaii Inc., Verizon Maryland Inc., Verizon New England Inc., Verizon New Jersey Inc., Verizon New York Inc., Verizon Pennsylvania Inc., Verizon Virginia Inc., Verizon Washington, DC Inc., Verizon West Virginia Inc., and Verizon West Coast Inc.

1. Under various agreements identified below, Verizon and the Debtors owe each other certain sums. Pursuant to a Stipulation entered by this Court, Verizon notified the Debtors that it intended to setoff approximately $9.6 million in debts that the Verizon entities owe to VarTec Telecom, Inc. ("VarTec") and Excel Telecommunications, Inc. ("Excel") against debts owed to those Verizon entities by VarTec and Excel. In response, the Debtors objected to the setoff and then later filed the Motion. In the Motion, the Debtors contend that Verizon is only permitted to setoff approximately $4,113,878 in debts owed by VarTec and Excel to Verizon, rather than the $9.6 million in debts Verizon asserts are subject to setoff. The Debtors assert that the lower setoff amount is proper because two elements of setoff – mutuality of parties and mutuality of capacity – are purportedly lacking to effect the full $9,598,038 setoff. The Debtors' position is without merit.

2. The Debtors contend that Verizon does not meet the mutuality of parties requirement because Verizon calculated its setoff claim by combining the debts owed by the various Verizon entities under a B&C Agreement (as defined below) against the amounts owed by the Debtors. According to the Debtors, Verizon should not have combined the debts that it owes to the Debtors, and should not have combined the debts that the Debtors owe to Verizon. A straightforward reading of the B&C Agreement, however, disposes of this contention. The combining of the debts owed by Verizon is quite proper because the B&C Agreement clearly makes the claims and debts of each separate Verizon entity the claims and debts of all of the Verizon entities. Further, even if there were no joint and several liability of the Verizon entities under the B&C Agreement (which there is), the parties expressly agreed to aggregation of debts under the B&C Agreement, thereby satisfying the mutuality requirement as a matter of contract law. Any claim the Debtors may have that the claims and debts of the Debtors under the B&C

Agreement cannot be aggregated for setoff purposes is equally unavailing because they are bound by the terms of the B&C Agreement, which permits the aggregation of any debts owed by the Debtors to Verizon, and Verizon to net any such payables against the payables owed by Verizon.

3. As for the Debtors' argument that mutuality of capacity does not exist, this argument also falls well short. Contrary to the contentions of the Debtors, no agency relationship existed between Verizon and the Debtors. Rather, Verizon and the Debtors hold claims against each other in the capacity of debtors or creditors, as the case may be. Therefore, setoff is permissible. Moreover, even if an agency relationship existed (which it does not), Verizon's setoff still would be proper because it is based in contract.

4. For these reasons, which are set forth in more detail below, the Court should sustain Verizon's objection and permit Verizon to effect the $9.6 million setoff.

BACKGROUND

A. Procedural Background

5. On November 1, 2004 (the "Petition Date"), the Debtors each filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). The Debtors continue to operate their businesses and manage their property as debtors-in-possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

B. Verizon's Relationship with the Debtors

6. Prior to the Petition Date, certain of the Verizon entities entered into agreements with VarTec and Excel pursuant to which VarTec and Excel obtain the right to use Verizon's telecommunications network, including circuits, facilities and equipment, in certain states. Those agreements (the "Network Contracts") – interconnection agreements ("ICAs") and/or applicable tariffs – establish the terms, conditions and pricing under which Verizon provides

VarTec and Excel with access to Verizon's network and under which VarTec and Excel resell Verizon's local telephone service for the benefit of their end user customers.

7. A Billing Services Agreement with an effective date of August 1, 2002 (the "B&C Agreement") was also entered into between the parties. Attached hereto as Exhibit A is a copy of the B&C Agreement.[2] Under the B&C Agreement, Verizon purchases accounts receivable that are owed by Verizon's local telephone customers who use the Debtors for long distance service. (B&C Agreement at § 9.) Specifically, the B&C Agreement states that "VERIZON shall purchase accounts receivable for Accepted Billing Records." (See B&C Agreement at § 9.1) "Accepted Billing Records" are defined in the B&C Agreement as "data which has been transmitted by VARTEC or its network provider to VERIZON for billing and has passed all VERIZON format requirements and up front edit checks." (See B&C Agreement at Attachment B.) Verizon also is entitled to receive payment of certain fees and charges as specified in the B&C Agreement.

8. On December 2, 2004, the Court entered the *Stipulation and Consent Order by and Among Certain Carriers and the Debtors Regarding Adequate Assurance/Adequate Protection of Future Payments* (the "Stipulation") which, among other things, established the procedures governing the assertion of setoff claims by Verizon and, in the event of dispute relating to the setoff claims, the manner by which such disputes would be resolved. (Stipulation at ¶ 9(A)-(H). Pursuant to and in compliance with the Stipulation, Verizon issued the setoff notice attached hereto as Exhibit B on February 8, 2005 (the "Setoff Notice"). Among other things, the Setoff Notice identified the debts owing between the parties under the B&C Agreement, the net Verizon payable to the Debtors under the B&C Agreement, the amount

[2] VarTec, Excel and Verizon were parties to various billing agreements that predate the B&C Agreement. The B&C Agreement replaced these prior agreements between the parties.

owing by each of VarTec and Excel to each Verizon entity under the Network Contracts, the pro rata application of the net Verizon payable to the Debtors to the receivables owed by VarTec and Excel to each Verizon entity, and the net remaining claims of the Verizon entities after application of the setoff. Thereafter, the Debtors served their cursory objection to the Setoff Notice.[3]

9. As of the Petition Date, VarTec was indebted to Verizon for telecommunications services and facilities in the amount of $4,821,853.40. Excel was indebted to Verizon for telecommunications services and facilities in the amount of $2,168,701.48 as of the Petition Date. The Debtors also were indebted to Verizon under the B&C Agreement in the amount of $3,842,471.90. Verizon was indebted to the Debtors under the B&C Agreement in the amount of $9,636,744.02 as of the Petition Date.[4] As set forth in detail below, Verizon is entitled to setoff these mutual debts, resulting in a net prepetition debt owing to Verizon in the amount of $1,196,282.76.[5]

ARGUMENT AND CITATION TO AUTHORITY

A. Verizon Is Entitled To Effectuate a Setoff Against the Debts of VarTec and Excel

10. Section 553 governs setoffs in bankruptcy and provides, in relevant part:

> [T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement

[3] Although the Debtors claim now that it is unclear how Verizon arrived at the amounts in its Setoff Notice (Motion ¶ 26) and that the Debtors attempted to confer with Verizon but failed to achieve any progress towards resolution (Motion ¶ 22), those statements simply are not accurate. At no time did Verizon refuse to provide any information requested by the Debtors. Moreover, Verizon attempted to resolve this matter with the Debtors through business to business contacts, but it was the Debtors who refused to have further discussions.

[4] In paragraph 18 of their Motion, the Debtors assert that Verizon also owes approximately $418,600 to the Debtors postpetition under the B&C Agreement. The Debtors are not seeking to recover this money in their Motion, but have reserved their rights in the event a resolution is not reached with respect to that sum. The $418,600 relates to a final true-up under the B&C Agreement following the termination of the agreement. The detailed billing statements actually reveal that the Debtors owe $114,000 to Verizon postpetition for the final true-up under the B&C Agreement. Verizon has provided the documentation of this amount to the Debtors' representatives and has advised them that the Verizon personnel are available to answer any questions regarding the documentation.

[5] The amounts set forth in this paragraph vary somewhat from the Setoff Notice because they are based on more current information regarding the amounts owing between the parties.

> of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.

11 U.S.C. § 553(a). Section 553 does not itself create a right of setoff, but rather preserves whatever rights of setoff exist under applicable non-bankruptcy law. In re Bennet Funding Group, Inc., 146 F.3d 136, 138-39 (2d Cir. 1998). Pursuant to the terms of the B&C Agreement -- the contract under which Verizon seeks to exercise its setoff right -- the agreement is governed by New York law. (B&C Agreement, § 29.1). New York recognizes both equitable and statutory setoff. In re Prudential Lines, Inc., 148 B.R. 730, 751 (Bankr. S.D.N.Y.1992), aff'd in part and rev'd in part on other grounds, 170 B.R. 222 (S.D.N.Y.1994).

11. A source of statutory setoff applicable to the instant case has been established by New York Creditor and Debtor Law § 151, which allows setoff by one who is owed a debt after the filing of a bankruptcy petition by or against its creditor.[6] Under New York law, to offset debts, they must be mutual. Beecher v. Peter A. Vogt Mfg., 227 N.Y. 468, 473, 125 N.E. 831 (1920).

i. Mutuality of Parties between Verizon and the Debtors

[6] New York Creditor and Debtor Law § 151 provides in relevant part:

> Every debtor shall have the right upon:
>
> (a) the filing of a petition under any of the provisions of the federal bankruptcy act or amendments thereto . . . by or against a creditor;
>
> . . . . .
>
> to set off and apply against any indebtedness, whether matured or unmatured, of such creditor to such debtor, any amount owing from such debtor to such creditor, at or at any time after, the happening of any of the above mentioned events, and the aforesaid right of set off may be exercised by such debtor against such creditor or against any trustee in bankruptcy, debtor in possession . . .

N.Y. Debtor and Creditor Law § 151 (McKinney 2001).

a. Combining the Claims and Liabilities of Verizon under the B&C Agreement is Proper

12. The Debtors contend, cursorily, that Verizon does not meet the mutuality requirement because Verizon calculated its setoff claim by combining the debts owed by the various Verizon entities under the B&C Agreement against the amounts owed by the Debtors under the B&C Agreement. (See Motion at ¶ 27.) A straightforward reading of the B&C Agreement, however, makes it clear that Verizon is permitted to do so. Each Verizon entity is a party to the B&C Agreement, as demonstrated by the first paragraph of the B&C Agreement ("This Billing Services Agreement . . . is entered into between VERIZON . . . acting on behalf of its affiliated operating telephone companies . . . .") and the signature block of the B&C Agreement ("VERIZON Telephone Operating Companies Listed on Attachment A" (which has all entities defined as Verizon in this Objection)). Each Verizon entity is jointly and severally liable for each debt owed by Verizon under the B&C Agreement and each Verizon entity is jointly and severally entitled to the benefit of the obligations owing by the Debtors under the B&C Agreement.[7] Therefore, it is proper to aggregate the Verizon obligations under the B&C Agreement and to apply those obligations pro rata to any debts owing by the Debtors to Verizon.

13. Aggregation is also proper because the parties expressly agreed to it in the B&C Agreement.

14. Generally, "triangular setoff" – that is, where two entities aggregate their debts and claims against a third entity for setoff purposes – is not permitted. However, an exception to this rule exists where there is a formal agreement by the debtor that entities may aggregate debts owed to and from the debtor. See, e.g., In re K Town, Inc., 171 B.R. 313, 319 (Bankr. N.D. Ill. 1994) (although common law setoff limits setoff to "identical legal entities," contractual right to

[7] See, e.g., B&C Agreement at §§ 9.1 and 9.3 (providing for "VERIZON" to purchase receivables from the Debtors).

setoff between two accounts can provide the requisite mutuality for § 553); Bloor v. Shapiro, 32 B.R. 993, 1001-02 (S.D.N.Y. 1983); Piedmont Print Works v. Receivers of People's State Bank of South Carolina, 68 F.2d 110, 111 (4th Cir. 1934) (finding mutuality where such an agreement and an "identity of interests" between company and its subsidiary were established); In re Hill Petroleum Co., 95 B.R. 404 (Bankr. W.D. La. 1988); Matter of Fasano/Harriss Pie Co., 43 B.R. 864 (Bankr. W.D. Mich. 1984); Bromfield v. Trinidad Nat. Inv. Co., 36 F.2d 646 (10th Cir. 1929).

15. In the B&C Agreement, the parties formally agreed that the Verizon entities could aggregate debts owed to and by the Debtors for setoff purposes. This is evidenced by Section 11.6 of the B&C Agreement, which specifically provides:

> In the event that . . . VARTEC[8] fails to pay amounts that are undisputed and owing within thirty (30) Days of the invoice preparation date, VERIZON . . . may net any undisputed amounts due by VARTEC to VERIZON against the PAR amounts due VARTEC under the Agreement.

Also, Section 4.6 of the B&C Agreement provides that:

> Notwithstanding anything to the contained herein to the contrary, VERIZON reserves the right to deduct from the sums due VARTEC any amounts owed by VARTEC to VERIZON where the amounts are past due and have not yet been paid.

These provisions clearly evidence the intent of the parties to treat the Verizon entities as a single entity. Therefore, Verizon meets the mutuality requirement as a matter of contract law, and for this additional reason is entitled to setoff its obligations pro rata with any debts owing by the Debtors to Verizon.

b. Combining the Claims and Liabilities of the Debtors is Proper Under the B&C Agreement

16. The Debtors also seem to contend that the claims and debts of the Debtors cannot

[8] As discussed in paragraph 17 below, the term "VARTEC" in the B&C Agreement is defined to include the name Excel Telecommunications, Inc.

be aggregated for setoff purposes. ("The amounts that VarTec consents to are only those amounts arising from mutually-owing prepetition obligations between the same single, specific Verizon entity and the same, single specific Debtor entity under the B&C Agreement." Motion at ¶ 34.) Verizon agrees and acknowledges that, unless the Debtors are substantively consolidated or are found to be alter egos of each other, the debts of the Debtors under the Network Contracts cannot be aggregated. Verizon's setoff notice, however, did not seek to aggregate the debts of the Debtors under the Network Contracts, but only the combined debts of the Debtors under the B&C Agreement.

1) The Plain Language of the B&C Agreement Provides for Aggregation

17. The Debtors' Motion simply fails to explain why the debts of the Debtors would not be aggregated under the plain language of the B&C Agreement. The term "VARTEC" in the B&C Agreement is defined to include the name Excel Telecommunications, Inc. The Debtors note in their Motion that "[t]he B&C Agreement incorrectly sets forth Excel Telecommunications, Inc. as a d/b/a of VarTec" and claim that "Excel is a separate legal entity" (Motion at ¶ 14). Nowhere, however, do the Debtors deny (nor could they) that for years Excel sold and Verizon purchased Excel's accounts receivable under the B&C Agreement and continued this course of dealing postpetition. Indeed, the B&C Agreement specifically identifies Excel's "CIC" Code (00752/EXL) and provides that Verizon is to purchase the receivables under that Excel CIC Code. (B&C Agreement at §1.3 and Service Attachment 1.) Moreover, the Debtors' statement in paragraph 34 of their Motion quoted above implicitly acknowledges that multiple Debtors have claims and obligations under the B&C Agreement. In any event, given the replacement of the Excel billing and collection contracts with the B&C Agreement and Excel's continuous operation under the terms of the B&C Agreement for years, it is beyond cavil

that Excel would be bound by the terms of the B&C Agreement. See, e.g., 2nd Restatement of Contracts, § 4 (assent to a contract "may be manifested by words or other conduct"); Haws & Garrett General Contractors, Inc. v. Gorbett Bros. Welding Co., 480 S.W.2d 607, 609 (Tex. 1972) (contract can be implied in fact based on the parties' conduct).

18. Sections 4.6 and 11.6 of the B&C Agreement, quoted in paragraph 15 above, specifically permit the aggregation of any debts owed by the Debtors to Verizon and Verizon to net any such amounts against the payables owed by Verizon. Therefore, it is entirely proper under the B&C Agreement for Verizon to offset amounts that it owes to any of the Debtors under the B&C Agreement against amounts that any Debtor has failed to pay to Verizon, including amounts owed under the B&C Agreement or the Network Contracts.

2) Separately, Equity Also Dictates that the Claims and Liabilities of the Debtors Should be Combined

19. It should also be noted that, regardless of whether the provisions of the B&C Agreement specifically provide for aggregation of the Debtors' debts for setoff purposes, aggregation should still be permitted due to the circumstances of this case and the course of dealing between the Debtors and Verizon. As discussed above, "triangular setoff" is generally not permitted. However, this Court has recognized that the strict mutuality rule may be relaxed when necessary to prevent irremedial injustice. See In re Braniff Airways, Inc., 42 B.R. 443, 448 (Bankr. N.D. Tex. 1984) ("[A]lthough a court of equity could permit setoff even though mutuality is wanting, it should decline to do so absent a showing of irremedial injustice"); accord Modern Settings, Inc. v. Prudential-Bache Securities, Inc., 936 F.2d 640 (2d Cir.1991) ("there may be an exception to the strict mutuality rule where an injustice would be caused by disallowing a set-off . . . ."); In re Express Parts Warehouse, Inc., 230 B.R. 526 (Bankr. E.D.N.C. 1999) (holding that because setoff is an equitable remedy, court may allow lessor to setoff

administrative expense claim for postpetition rent against lessor's obligation to debtor on prepetition promissory note); In re Westchester Structures, Inc., 181 B.R. 730 (Bankr. S.D.N.Y. 1995) (stating that, under New York law, "the right to setoff is within the court's discretion and it may invoke equity to bend the rules, if required, to avert injustice"); In re Allegheny International, Inc., 1990 WL 514353 (Bankr. W.D. Pa. 1990) (relaxing mutuality and permitting setoff for equitable reasons).

20. In the instant case, to the extent necessary, the Court should relax the mutuality rule so as to allow for the aggregation of any debts owed by the Debtors to Verizon for setoff purposes because injustice would be caused by disallowing such aggregation. First, the Debtors have disclosed their intentions to substantively consolidate their estates. In the *Debtor's Omnibus Objection to the Motions for the Appointment of an Additional Committee Pursuant to 11 U.S.C. § 1102(a)(2),* the Debtors argued against the formation of an additional committee to represent Excel's creditors in part on the basis that it would be improvident given that "the Debtors have announced their intention to seek a formal substantive consolidation of the Debtors' estates in the near future."[9] Once the Debtors' estates are substantively consolidated, the separateness of VarTec's and Excel's corporate structures would be disregarded and their assets and liabilities would be pooled, mooting any mutuality argument the Debtors may have. See In re Babcock and Wilcox Co., 250 F.3d 955, 958 n.5 (5th Cir. 2001) (quoting Norton Bankruptcy Law and Practice § 20:3 (2d ed. 2000) for the proposition that "[s]ubstantive consolidation occurs when the assets and liabilities of separate and distinct legal entities are combined in a single pool and treated as if they belong to one entity.")

[9] Given that VarTec and Excel appear to have acted as alter egos of each other under the B&C Agreement, substantive consolidation appears to be entirely appropriate in this case.

21. It would be unjust not to allow Verizon to setoff Excel's debts where the Debtors intend to substantively consolidate their assets and liabilities. See In re Braniff Airways, Inc., 42 B.R. 443 (Bankr. N.D. Tex. 1984) (refusing to permit a debtor to effect setoff in such a way as to undermine the priority scheme enacted by Congress). At the very least, it would be premature for the Court to foreclose Verizon's setoff rights now without the Court making a definitive ruling on whether the Debtors' estates will be substantively consolidated.

22. Furthermore, it would be unjust not to allow Verizon to setoff Excel's debts because VarTec and Excel have been holding themselves out as parties to the B&C Agreement. As admitted by the Debtors in their Motion, the B&C Agreement identified "Excel Telecommunications, Inc." (B&C Agreement, p. 1.) Although the Debtors claim in their Motion that "[t]he B&C Agreement incorrectly sets forth Excel Telecommunications, Inc. as a d/b/a of VarTec," both VarTec and Excel have been acting under the terms of the B&C Agreement for years. Verizon was led to believe that Excel and VarTec were parties to the agreement or were one and the same. Therefore, it would be unjust not to treat them as parties to the agreement or as one company for setoff purposes now.

23. For these reasons, to the extent necessary, the mutuality requirement as it relates to the setoff of Excel's debts should be relaxed.

c. The Debtors' Entity by Entity Argument Would Have a Far Smaller Effect than the Debtors Contend.

24. The Debtors contend that only the sum of $4,113,878 would constitute an appropriate setoff on an entity by entity basis. (Motion, ¶ 17.) Consequently, under their view, Verizon should pay to the estate the sum of $5,484,160. (Motion, ¶ 17.) However, even if the Court did not permit aggregating the claims of the various parties (and it is plain that the Court

should permit such aggregation), the net amount owed to the Debtors after such a strict mutuality setoff would still be only close to $1 million, and not the $5,484,160 claimed by the Debtors.

ii. Mutuality of Capacity

25. The Debtors also contend that the B&C Agreement created an agency relationship between Verizon and the Debtors,[10] which prevents Verizon from setting off the payables that Verizon owes to the Debtors under the B&C Agreement against the amounts that the Debtors owe to Verizon under the Network Contracts. (Motion at pp. 12-14.) It is clear from the terms of the B&C Agreement and the substance of the parties relationship, however, that Verizon was not acting as the Debtors' agent under the B&C Agreement. Moreover, even if Verizon were the Debtors' agent under the B&C Agreement, which it was not, the Debtors' contention does not preclude setoff because Verizon's setoff right is based in contract, which satisfies (or makes irrelevant) any mutuality of capacity requirement for setoff.

26. The terms of the B&C Agreement and the substance of the parties' relationship show that Verizon was not acting as the Debtors' agent under the B&C Agreement. Under the B&C Agreement, Verizon purchased the accounts receivable from the Debtors, and did not collect them on the Debtors' behalf as an agent. The B&C Agreement specifically provides that "VERIZON shall purchase accounts receivable for Accepted Billing Records." (See B&C Agreement at § 9.1.) "Accepted Billing Records" are defined in the B&C Agreement as "data which has been transmitted by VARTEC or its network provider to VERIZON for billing and has passed all VERIZON format requirements and up front edit checks." (See B&C Agreement at Attachment B.) The B&C Agreement further provides that "VERIZON shall purchase accounts receivable from VARTEC on a monthly basis." (See B&C Agreement at § 9.3.)

[10] The Debtors also claim, without support, that the relationship can be characterized as "that of a bailee or trustee." (Motion, p. 12 fn. 5.)

Because the receivables were purchased by Verizon, it is plain that there was no agency.

27. In addition, section 22.1 of the B&C Agreement sets forth the parties' specific intent not to create an agency relationship. Instead, they agreed that they were acting solely as independent contractors. (See B&C Agreement, § 22.1 ("each Party shall perform its obligations of this Agreement as an independent contractor")).

28. Further, the Debtors lacked control of the payments collected by Verizon. An essential characteristic of any agency relationship is that the agent acts subject to the principal's direction and control. In re Shulman Transport Enterprises, Inc., 744 F.2d 293 (2nd Cir. 1984). In the instant case, Verizon did not have a duty to segregate the funds it collected — a monthly payment to VarTec by Verizon out of its general funds was sufficient. In Shulman, the Second Circuit Court of Appeals addressed the claim of an airline that the debtor, a freight forwarder, held as the airline's agent the funds it received for freight shipments made through the airline. 744 F.2d at 295-96. The court rejected this claim, ***even though there was an agreement between the airline and the debtor specifying an agency with respect to these funds.*** Rather, the court looked to the substance of the relationship between the parties, and found a debtor-creditor relationship, based principally on the control that the debtor exercised over the funds: "If there was no contractual duty to remit the proceeds of sale but payment monthly out of [the debtor's] general funds was sufficient, an extension of credit would be established." Id. at 296.

29. The First Circuit Court of Appeals, in In re Morales Travel Agency, 667 F.2d 1069, 1071-73 (1st Cir. 1981), similarly rejected an airline's contention that a debtor travel agent held the proceeds of ticket sales in trust for the airline, again ***despite an agreement between the parties that purported to establish such a trust.*** The control that the debtor exercised over the ticket proceeds was the principal factor on which the court relied: "[The

debtor] was left free to use what it received for its own benefit rather than [the airline's], and to transform the receipts into assets with no apparent encumbrance, upon which potential creditors might rely." 667 F.2d at 1071. The court made it clear that its rejection of the alleged trust would have applied equally had the airline been claiming an agency relationship:

> [O]ur holding would be the same even were we to find that the relation was intended to be one of principal/agent or consignor/consignee. In either such relationship, a principal or consignor who allows property to appear that of the agent's or consignee's estate will in the event of the latter's bankruptcy be estopped from recovering that property from the trustee. . . .

Id.

30. Here, as in the aforementioned cases, no agency or trust relationship exists because Verizon did not have a duty to segregate the receivables it collected. Rather, Verizon purchased the receivables from the Debtors, collected the receivables on its own behalf, and made payment to the Debtors for the purchased receivables. There was no requirement for Verizon to segregate the collected receivables and pass those segregated receivables on to the Debtors. In other words, had Verizon been the one to file for bankruptcy, the Debtors simply would have been general unsecured creditors in Verizon's bankruptcy case with respect to the Verizon payables. Consequently, no agency relationship existed between Verizon and the Debtors. See Shulman Transport, 744 F.2d at 296; Morales Travel, 667 F.2d at 1071. Therefore, since there was no agency relationship and Verizon and the Debtors hold claims against each other as debtor/creditors, mutuality of capacity exists so as to permit setoff by Verizon of the amounts it owes under the B&C Agreement against the amounts owed to it under the Network Contracts.

31. Even if Verizon had been acting as the Debtors' agent (which it was not), such a relationship would be irrelevant to the issue of whether Verizon can setoff the payables that Verizon owes to the Debtors under the B&C Agreement against the amounts that the Debtors owe

to Verizon under the Network Contracts. The "same parties" and "capacity" concepts are closely related and, indeed, courts sometimes merge these related concepts. See In re Warren, 93 B.R. 710, 711-12 (Bankr. C.D. Cal. 1988). As discussed in paragraph 14 above, any debts can be setoff by agreement. That is true regardless of whether a party is acting in a different capacity. See, e.g., In re Franklin Sav. Corp., 182 B.R. 859, 862-64 (D. Kansas 1995) (finding that, although a parent corporation generally holds a tax refund in trust for its subsidiaries, the parties' agreement varied the general rule). Here, sections 4.6 and 11.6 of the B&C Agreement plainly provide for the contractual setoff of any sums owed by Verizon to the Debtors against any sums owed by the Debtors to Verizon. Thus, even if Verizon was acting as the Debtors' agent (which it was not), that relationship would be irrelevant.

B. Scheduling

32. Federal Rule of Civil Procedure 17, as incorporated by Federal Rule of Bankruptcy Procedure 7017, requires that "[e]very action shall be prosecuted in the name of the real party in interest." As the Court is aware, the Debtors have filed a Motion For Authority To Sell Assets Free And Clear Of All Liens, Claims, Rights, Interests And Encumbrances And For Related Relief (the "Sale Motion"). The Sale Motion is scheduled for a hearing on July 27, 2005. If the Court approves the Sale Motion, the Debtors will no longer be the real party in interest.

33. Attached to the Sale Motion is an Asset Purchase Agreement ("APA"). The APA provides for the ultimate disposition of the Verizon payables that are the subject of the Motion, but based on circumstances that are, at present, entirely uncertain and contingent. In particular, to the extent those payables are recoverable, the APA provides that any payables related to any ILEC with whom the Buyer enters into an undefined "material commercial relationship" prior to

the Final Closing Date are "Acquired PARs." (All capitalized terms used but not defined in this Response have the meanings ascribed to them in the APA.) The APA provides that "Acquired PARs shall be an Acquired Asset as of the Final Closing and Buyer shall be free to dispose of Acquired PARs in any manner, including in settlement, compromise or other arrangement with the relevant ILEC." (APA § 5.16(a) (emphasis added).) The APA further provides that any litigation with such ILECs, such as the Motion at issue here, will be at the Buyer's direction under the MSA to be entered into between the Debtors and the Buyer. (Id.) To the extent that the Buyer does not enter into a "material commercial relationship" with an ILEC, however, the associated PARs are considered "Retained PARs," and any litigation with such ILECs will be at the direction of the Debtors' secured lender, the Rural Telephone Finance Cooperative ("RTFC"). Moreover, any recovery of Retained PARs would be split 50/50 between the RTFC and the Buyer (APA § 5.16(b)). In short, at present it is not clear whether the Debtors, the Buyer or the RTFC will be the real party in interest as of July 27, 2005.

34. Additionally, in the event that the Debtors' contracts with Verizon are assumed in connection with the sale, that assumption will effectively moot any litigation as to setoff. In other words, because the Debtors would be required to cure the outstanding indebtedness owed to Verizon to assume the Verizon contracts, there no longer would be any debt owing by the Debtors to Verizon against which to apply the debts owing by Verizon to the Debtors.

35. As the Court is aware from the record in this case, including specifically the hearing held on June 27 and June 28 on the Debtors' bid procedures motion, the Debtors' contracts with the ILECs (including Verizon) are critical to the Debtors' business and it is in the Buyer's interest to reach agreement with the carriers or the business could not survive. Counsel for the Buyer and the Debtors represented on the record that the Buyer would be conducting

negotiations to reach a resolution of the assumption and cure issues in advance of the hearing on the Sale Motion and, indeed, the Court cautioned that the Court's Local Rules require good faith negotiations to resolve objections.

36. In light of the mandate of Rule 17 that litigation be prosecuted only by the real party in interest, and because the Sale Motion will be heard as soon as the end of this month and may result in the mooting of the setoff litigation by the assumption of the Verizon contracts, it would be inappropriate to undertake litigation with respect to this matter until after August 1. Indeed, the parties' resources would be far better served by the devotion of resources to resolution of the assumption and setoff issue over the next several weeks rather than by litigation during that period.

37. Whenever the Motion does proceed (if it is not mooted by the assumption of the Verizon contracts), as demonstrated above, the two basic issues raised by the Debtors are disposed of easily in Verizon's favor based on the plain language of the B&C Agreement. Thus, while there may need to be discovery and a trial with respect to specific amounts owing between the parties, the two basic issues (one being whether the combining of the debts of the Verizon entities and the Debtor entities is proper, and the other being whether the B&C Agreement created an agency relationship that prohibited the setoff of amounts owed by Verizon under the B&C Agreement against the amounts that the Debtors owe to Verizon under the Network Contracts) are susceptible of resolution in favor of Verizon as a legal matter. Therefore, Verizon would respectfully request that the Court consider hearing argument on, and disposing of, these two issues in Verizon's favor promptly.

38. To the extent that discovery needs to occur, it should take place after the Court determines whether it will dispose of those issues in Verizon's favor as a legal matter. A

reasonable schedule thereafter would approximate the following:[11]

Date	**Action**
20 days after commencement of discovery period	Rule 7026(a) Disclosures
60 days after commencement of discovery period	Disclose Experts
90 days after commencement of discovery period	Discovery Ends
30 days after close of discovery	Deadline to File SJ Motions
TBD based on SJ briefing and hearing schedule	Exchange and file exhibits and witnesses
TBD based on SJ briefing and hearing schedule	File and Serve Pretrial Order

[11] Verizon observes that, as discussed in Section A(i)(b) above, the Debtors seem to contend that the claims and debts of the Debtors cannot be aggregated for setoff purposes. As explained in that section, the Debtors are incorrect. If, however, the Court were to disagree, then the impact of substantive consolidation would become relevant to the determination of Verizon's setoff rights. In that event, it would not be appropriate for the Court to rule on the Motion until after a Plan has been filed and confirmed in the Debtors' cases. While Verizon does not now seek to delay going forward with the resolution of the Motion on other grounds, Verizon expressly reserves its rights as to the impact that substantive consolidation would have on Verizon's setoff rights. Indeed, in that event, it would be necessary to adjourn a final ruling on the Motion until after a decision on substantive consolidation.

Date	Action
TBD based on SJ briefing and hearing schedule	Findings of Fact/Law and Trial Briefs
TBD based on SJ briefing and hearing schedule	Docket Call
TBD	Trial

WHEREFORE, Verizon respectfully requests that the Court sustain Verizon's Objection and permit Verizon to perform the setoff described in the Setoff Notice.

Dated: July 5, 2005

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on July 5, 2005, I caused to be served a copy of the foregoing *Response Of The Operating Telephone Company Subsidiaries Of Verizon Communications Inc. To Debtors' Motion To Determine The Verizon Entities' Ability To Effectuate Setoff And Compel Compliance With The Carriers' Stipulation* via (i) email to the CM/ECF participants that receive electronic notification in these proceedings by electronically filing same with the Clerk of the Court using the CM/ECF system; and (ii) United States mail by causing a copy of same to be deposited in the United States mail, first-class postage prepaid, addressed as follows:

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