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**ATTORNEYS FOR THE DEBTORS**

**IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE NORTHERN DISTRICT OF TEXAS  
DALLAS DIVISION**

<b>IN RE:</b>	§	
	§	
<b>VARTEC TELECOM, INC., et al.,</b>	§	<b>CASE NO. 04-81694-SAF-11</b>
	§	
<b>DEBTORS.</b>	§	<b>(Chapter 11)</b>
	§	<b>(Jointly Administered)</b>

**FIRST AMENDED MOTION TO DETERMINE THE  
VERIZON ENTITIES' ABILITY TO EFFECTUATE SETOFF**

**TO THE HONORABLE STEVEN A. FELSENTHAL, UNITED STATES CHIEF  
BANKRUPTCY JUDGE:**

**A STATUS CONFERENCE WILL BE CONDUCTED ON THIS MATTER ON JULY 7, 2005, AT 3:30 P.M. IN THE COURTROOM OF THE HONORABLE STEVEN A. FELSENTHAL, 1100 COMMERCE STREET, 14TH FLOOR, DALLAS, TEXAS. IF YOU OBJECT TO THE RELIEF REQUESTED, YOU MUST RESPOND IN WRITING, SPECIFICALLY ANSWERING EACH PARAGRAPH OF THIS PLEADING. UNLESS OTHERWISE DIRECTED BY THE COURT, YOU MUST FILE YOUR RESPONSE WITH THE CLERK OF THE BANKRUPTCY COURT WITHIN TWENTY (20) DAYS FROM THE DATE YOU WERE SERVED WITH THIS PLEADING. YOU MUST SERVE A COPY OF YOUR RESPONSE ON THE PERSON WHO SENT YOU THE NOTICE; OTHERWISE, THE COURT MAY TREAT THE PLEADING AS UNOPPOSED AND GRANT THE RELIEF REQUESTED.**

The above-referenced debtors and debtors in possession (collectively, the “Debtors”)<sup>1</sup> file this Motion to Determine the Verizon Entities’ Ability to Effectuate Setoff (the “Motion”) and in support would show as follows:

### **JURISDICTION AND PROCEDURAL BACKGROUND**

1. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334 and 157. The Motion concerns the administration of the estate; and therefore, it is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A) and (E).

2. Venue is proper in this Court pursuant to 28 U.S.C. §§ 1408 and 1409.

3. On November 1, 2004 (the “Petition Date”), the Debtors each filed a voluntary petition for relief (collectively, the “Cases”) under chapter 11 of title 11 of the United States Code (the “Bankruptcy Code”).

4. Since the Petition Date, the Debtors have continued to operate and manage their businesses as debtors in possession pursuant to Bankruptcy Code §§ 1107(a) and 1108.

5. The Debtors’ Cases are jointly administered under the Case styled *In re VarTec Telecom, Inc.*; Case No. 04-81694-SAF-11.

### **STATEMENT OF FACTS**

#### **VarTec and Its Business**

6. VarTec Telecom, Inc., a Texas corporation, (“VarTec”) along with its sixteen direct and indirect domestic subsidiaries, each of which is a Debtor, and two

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<sup>1</sup> The Debtors include VarTec Telecom, Inc., Excel Communications Marketing, Inc., Excel Management Service, Inc., Excel Products, Inc., Excel Telecommunications, Inc., Excel Telecommunications of Virginia, Inc., Excel Teleservices, Inc., Excelcom, Inc., Telco Communications Group, Inc., Telco Network Services, Inc., VarTec Business Trust, VarTec Properties, Inc., VarTec Resource Services, Inc., VarTec Solutions, Inc., VarTec Telecom Holding Company, VarTec Telecom International Holding Company, and VarTec Telecom of Virginia, Inc.

remaining non-debtor direct and indirect foreign subsidiaries (collectively, the “VarTec Entities”), is among the largest privately held companies providing telecommunications services in North America. The VarTec Entities, founded in DeSoto, Texas, in February 1989, with approximately 900 current employees, sell a full range of telecommunication products and services to customers. In 2003, the VarTec Entities had revenues of approximately \$1,260,000,000 and 2004 revenues in the approximate amount of \$900,000,000. As of the Petition Date, VarTec’s revenues had been derived primarily from three sale distribution channels: (a) Direct Marketing; (b) Commercial Services; and (c) Multi-Level Marketing.

7. The Direct Marketing channel, managed by VarTec and certain of its subsidiaries offers telecommunications services to small business and residential consumers, including local and long distance telephone services, wireless telephone services, and internet access. VarTec pioneered the “10-10 dial-around” long distance market by offering customers the opportunity to access VarTec’s discounted long distance services on a call-by-call basis by dialing “10-10” then a three-digit unique carrier access code. Under the “dial-around” model, a customer’s long distance usage is billed on her local phone service provider’s invoice, the local phone service provider collects the billed amounts, and the local phone service provider remits those collected amounts to VarTec.

8. While experiencing tremendous success with the “dial-around” model, VarTec began to offer other telecommunication services, including local and traditional long distance telephone services, wireless telephone service, and internet access, directly to small business and residential customers. VarTec is licensed to provide local

and long distance telephone services in all fifty states, and marketed its products and services through, among other means, direct mail and magazine insert campaigns composed of several hundred million items to persons in a targeted market each year. VarTec also uses outbound telemarketing for targeted campaigns to attract new customers of existing products and to offer new and/or additional products to existing customers.

9. The Commercial Services channel, managed by VarTec Solutions, Inc. (formerly known as eMeritus Communications, Inc.) and certain of its subsidiaries (collectively, "VarTec Solutions"), provides customized voice, data, and internet services to commercial and wholesale carrier customers throughout the U.S. VarTec Solutions' voice product offerings include switched and dedicated access, domestic and international toll-free service, calling cards, audio conferencing, and other specialized products. In addition, VarTec Solutions offers high-capacity data services that provide access to frame relay and IP networks. For carrier customers, VarTec Solutions offers the ability to co-locate their equipment inside carrier-class facilities, saving the cost and complications involved with building their own facilities.

10. Through the Multi-Level Marketing channel, which was managed by Excelcom, Inc. and certain of its subsidiaries (collectively, "Excel"), Excel offered telecommunications products and services to small business and residential consumers similar to those offered by VarTec to its customers. Excel, which was acquired by VarTec in 2002, had an international network of over 130,000 independent representatives (collectively, the "IRs") who marketed Excel's products and services to small business and residential consumers and recruited new IRs to market such

products and services. Each IR received commissions and bonuses based on, among other things, the success of the IRs recruited and a portion of the success of their recruits (referred to as a “downline”) and the usage of Excel products and services by customers of the IR and a portion of their downline. On March 1, 2005, the Court entered its Order [Docket No. 1026] authorizing the rejection of the Debtors’ executory contracts with each of the IRs effective as of the Petition Date.

### **Secured Debt**

11. VarTec is a borrower and the other Debtors (except VarTec Telecom of Virginia, Inc. and Excel Telecommunications of Virginia, Inc.) are guarantors under that certain First Amended and Restated Credit Agreement with the Rural Telephone Finance Cooperative (the “RTFC”), pursuant to which the existing secured indebtedness owing to the RTFC was restructured in the form of a secured term loan and a secured line of credit to the Debtor. The secured line of credit is in the form of a revolving credit facility, for the working capital, credit, and liquidity needed by the Debtor to conduct general business operations. As of the Petition Date, the obligations to the RTFC consisted of (a) a term loan of approximately \$154,000,000 and (b) a revolving line of credit with a total commitment of \$70,000,000.

### **The Industry**

12. Prior to 1996, local telecommunications services were provided exclusively by traditional, monopoly providers, or incumbent local exchange carriers (the “ILECs”). Pursuant to the Telecommunications Act of 1996 (the “Telecommunications Act”), which was enacted to promote competition in the local telecommunications industry, ILECs were required to provide competitors, such as the Debtors, access to

their networks to allow those competitive local exchange carriers (the “CLECs”) to offer local telecommunications services. The terms, conditions, and prices charged by ILECs to CLECs are provided in agreements – referenced as interconnection agreements – governed by rules and regulations promulgated by the Federal Communications Commission and various state agencies or public utility commissions.

### **Relationship With Verizon Entities**

13. Effective August 1, 2002, VarTec and Verizon<sup>2</sup> entered into the Billing Services Agreement dated July 26, 2002 (together with attachments, the “B&C Agreement”). Under the B&C Agreement, Verizon is required to bill VarTec’s end-users and collect funds from such end-users on behalf of and for the benefit of VarTec. Verizon receives a service charge for performing the task of billing and collecting payment from the Debtors’ corresponding end-users. The B&C Agreement places all risk of loss on VarTec as Verizon has reimbursement rights under the B&C Agreement to the extent that collections by Verizon are less than amounts paid by Verizon to VarTec under the B&C Agreement.

14. Under the B&C Agreement, VarTec includes its d/b/a’s VarTec, Clear Choice, and Telephone Express. *The B&C Agreement incorrectly sets forth Excel Telecommunications, Inc. (“Excel”) as a d/b/a of VarTec.* Excel is a separate legal entity.

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<sup>2</sup> “Verizon” includes the following entities under the B&C Agreement: Contel of the South, Inc. d/b/a Verizon Midstates, Verizon Midwest Incorporated, d/b/a Verizon Midwest, Verizon Southwest Incorporated, 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 North, Inc., Verizon Northwest, Inc., Verizon Pennsylvania, Inc., Verizon South, Inc., Verizon Virginia, Inc., Verizon Washington, DC, Inc., Verizon West Virginia, Inc., and Verizon West Coast, Inc.

15. Verizon has also entered into numerous other unrelated individual network services agreements with specific, individual Debtors for the corresponding Debtor's use of particular Verizon capacity and facilities (the "Network Services Agreements").

16. On December 2, 2004, the Court executed and entered the Stipulation and Consent Order by and Among Certain Carriers and the Debtors Regarding Adequate Assurance/Adequate Protection of Future Payments [Docket No. 451] (the "Carrier Stipulation"). The Carrier Stipulation was ordered by this Court to be binding upon the Carriers, including Verizon, and the Debtors, including all successors and assigns. The Carrier Stipulation also defines specific rights and obligations as well as technical procedures to govern obligations and liabilities between and among such parties.

17. According to the Debtors' books and records, Verizon has withheld at least \$9,598,038 of the Debtors' cash. Of that amount, a maximum of approximately \$4,113,878 is appropriate as a setoff by Verizon pursuant to the B&C Agreement. Nonetheless, Verizon has continued to withhold at least \$5,484,160 in additional funds (the "Withheld Funds") from the Debtors' estates that are payable currently to the Debtors under the B&C Agreement. Consequently, at least \$5,484,160 should be turned over to the Debtors' estates immediately.

18. Additionally, Verizon is holding at least \$418,600 of the Debtors' cash that is payable postpetition under the B&C Agreement and the provisions of the Carrier Stipulation. At this time, the Debtors and Verizon are attempting to negotiate a resolution to this issue. Accordingly, the Debtors reserve all their rights, claims and

remedies as to such amount in the event a voluntary agreement cannot be achieved in the near future.

### **RELIEF REQUESTED**

19. The Debtors request that the Court enter an order determining the existence and extent of Verizon's lawful setoff rights, if any, and ordering Verizon to turn over to the Debtors all withheld amounts, including but not limited to the Withheld Funds. The Debtors are in immediate need of the Withheld Funds for operations.

20. The relief requested is specifically authorized by the Carrier Stipulation. The Carrier Stipulation permits the Debtors to bring this action ninety days after December 2, 2004, the date the Carrier Stipulation was entered. See Carrier Stipulation, ¶ 9.E. In accordance with the terms of the Carrier Stipulation, the Motion is brought as a contested matter in this Bankruptcy Court, rather than as an adversary proceeding. ¶ 9.E.

21. Verizon is asserting setoff rights in amounts that it collected as a billing agent for VarTec against amounts that Verizon incurred providing different forms of services to the Debtors under separate agreements such as the Network Services Agreements. Distinguishable from Verizon's agency role under the B&C Agreement for billing and collection services, under the Network Services Agreements, no agency relationship existed between Verizon and the Debtors.

22. Over the course of several months, the Debtors attempted on numerous occasions to confer with Verizon in an attempt to resolve these matters. The Debtors' efforts included significant business person-to-business person attempts toward



resolution. The Debtors have not been able to achieve any progress with Verizon, necessitating the filing of the Motion.

**A. Verizon fails to meet all requirements to effectuate a setoff.**

23. The Bankruptcy Code does not by itself create a right of setoff. See *Citizens Bank of Maryland v. Strumpf*, 116 S.Ct. 286, 289 (1995). As a threshold inquiry, a creditor must have an independent right of setoff under applicable non-bankruptcy law.<sup>3</sup> See *id.* Only then, and to the extent the factors delineated in Bankruptcy Code § 553 are satisfied, will the Bankruptcy Code protect a right to setoff. See *Strumpf*, 116 S.Ct. at 289.

24. After establishing an independent right to setoff, in order to effectuate such a right under the Bankruptcy Code: (i) the debts must be mutual obligations; (ii) there must be mutuality of capacity of the parties; (iii) there must be mutuality of identity of the parties; and, (iv) there must be mutuality as to the nature of the mutual debts such that no prepetition debt may be offset against a postpetition debt. Courts strictly construe whether mutuality exists for exercising setoff. See *e.g.*, *Kitaeff v. Vappi & Co., Inc. (In re Bay State York Co.)*, 140 B.R. 608, 614 (Bankr. D. Mass. 1992). Accordingly, Verizon must establish all elements of mutuality in order to succeed on a claim for setoff. See *id.*

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<sup>3</sup> In order to exercise a setoff, Verizon generally must show: (1) a debt exists from the creditor to the debtor prior to the commencement of the bankruptcy case; (2) the creditor has a claim against the debtor which arose prior to the commencement of the bankruptcy case; and, (3) the debt and the claim are mutual obligations. *IRS v. Luongo (In re Luongo)*, 259 F.3d 323, 334 (5th Cir. 2001); *Braniff Airways, Inc. v. Exxon Co.*, 814 F.2d 1030, 1035 (5th Cir. 1987); *Trustee for the GPR Holdings v. Kerr-McGee Energy Services Corp.*, 43 Bankr. Ct. Dec. 168 (Bankr. N.D. Tex 2004). Courts typically apply the law of the state where the operative facts occurred to determine if the right to setoff is proper. See *Williams v. American Bank of the Mid-Cities, N.A. (In re Williams)*, 61 B.R. 567, 571 (Bankr. N.D. Tex. 1986) (“Although Section 553 preserves the right of setoff, the nature, existence and enforceability of claims sought to be setoff are determined by applying the law of the state where the operative facts occurred”) (citations omitted).

25. As this Court recently explained, if the setoff issue arises in bankruptcy, the offsetting obligations must be held by the same parties in the same capacity (that is, as obligor and obligee), must be valid and enforceable, and both obligations must arise either prepetition or postpetition, even if they arose at different times out of different transactions, for mutuality to be satisfied. *Trustee for the GPR Holdings v. Kerr-McGee Energy Services Corp.*, 43 Bankr. Ct. Dec. 168 (Bankr. N.D. Tex. 2004); *see also, Cohen v. Savings Building and Loan Com. (In re Bevill, Bresler and Schulman Asset Management Corp.)*, 896 F.2d 54, 59 (3d Cir. 1990) (to be mutual, the debts must be in the same right and between the same parties, standing in the same capacity). The distinction between the concept of “capacity” and the requirement that the obligations be owed between the “same parties” is that the latter refers to the identity of the parties versus the former which refers to the relationship with each other. *See Kitaeff*, 140 B.R. at 614. If the debts arise from the parties acting in different capacities, then setoff is not proper. *See Capital Concepts Properties 85-1 v. Mutual First, Inc.*, 35 F.3d 170, 175 (5th Cir. 1994).

26. In addition to lacking an underlying right of setoff of the Withheld Funds, Verizon failed to abide by the material requirements in the Carrier Stipulation as conditions precedent to a setoff attempt including not setting forth the documentation to support its alleged right to effectuate a setoff, thus, it is unclear how Verizon contrived the numbers for each entity in its Setoff Notice. Accordingly, Verizon has not established that mutuality of entities exist. Further, Verizon is seeking to setoff funds that it collected as an agent for VarTec under the B&C Agreement against amounts that various Debtors may owe Verizon under certain unrelated Network Services

Agreements. Accordingly, the requirements for capacity mutuality are not met. As a result of each of these independent grounds, Verizon's attempt to setoff funds is inappropriate.

**B. Verizon does not meet the mutuality requirement if its obligations flow to different entities.**

27. Verizon is unable to meet the mutuality requirement for proper setoff under Bankruptcy Code § 553. In addition to the other requirements, Verizon must show (i) that a single, specific Verizon entity is owed a specific prepetition amount by a single, specific Debtor; and, (ii) that the same single, specific Debtor owes the same single, specific Verizon entity a certain prepetition amount. Given the lack of required supporting documentation in its Setoff Notice, it is apparent that Verizon cannot show which specific Verizon entity is making a claim and which of the Debtors are involved and purportedly owe such specific Verizon entity money. Verizon is attempting to dodge the requirements for party mutuality.

**C. Verizon failed to fulfill conditions precedent for setoff.**

28. Although required by the Carrier Stipulation, Verizon failed to provide information necessary to determine any potential setoff. For example, Verizon failed to provide the basis for money purportedly owed to its respective entities. In addition, Verizon failed to provide, in its Setoff Notice or otherwise, the dates on which the obligations allegedly owed by the Debtors to Verizon arose, and vice-versa. Consequently, there is no way to determine the extent to which Verizon is attempting to setoff prepetition claims against postpetition debts.<sup>4</sup> In light of its vague assertions and

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<sup>4</sup> See 11 U.S.C. § 553; *Kosadnar v. Metropolitan Life Ins. Co.*, 62 F.3d 1011, 1014 (5th Cir. 1998) ("The Bankruptcy Court specifically disallows the setoff of pre-petition claims against post-petition earnings").

the inability to correlate amounts by entity, claim, or date, Verizon's attempt at setoff cannot survive even cursory scrutiny under governing legal precedent as well as the procedures outlined in the Carrier Stipulation.

29. In addition, Verizon alleges that it is entitled to a setoff, but glosses over the fact that the Debtors dispute that certain amounts are owed to Verizon. The amounts in dispute and liability issues must be determined before allowing any form of setoff relating to such amounts.

**D. An agency relationship exists between Verizon and VarTec.**

30. Verizon is seeking to exercise a setoff from funds that it collected solely in its capacity as a billing and collection agent for the Debtors under the B&C Agreements.<sup>5</sup> Verizon seeks to set off these sums against amounts that various Debtors may owe Verizon under particular Network Services Agreements relating to the use of Verizon's network capacity and facilities. Setoff is inappropriate as a result of, among other things, Verizon's inability to meet the strict requirements for mutuality in the roles in which the parties acted – capacity mutuality.

31. The B&C Agreement is governed by New York law. Under New York law there are three elements required to establish an agency relationship: (1) "there must be a manifestation by the principal that the agent shall act for him"; (2) "the agent must accept the undertaking"; and (3) "there must be an understanding between the parties that the principal is to be in control of the undertaking." See *Basic Books, Inc. v. Kinkos Graphic Corporation*, 758 F. Supp. 1522, 1546 (S.D.N.Y. 1991) (citing *S.E.C. v.*

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<sup>5</sup> Verizon's relationship to the Debtors under the B&C Agreement can also be characterized as that of a bailee or trustee. Verizon's role as agent, bailee, or trustee is that of a fiduciary, obligated to collect and pay the Debtors the funds it collects on behalf of the Debtors in such capacity.

*American Bd. of Trade, Inc.*, 654 F. Supp. 361, 366) (S.D.N.Y.) (*aff'd* in part, *dism'd* in part, 830 F.2d 431) (2d Cir. 1987). An actual agency relationship existed as a result of the manifestation provided by the Debtors to, and accepted by, Verizon. Verizon had actual authority to act as a billing and collection agent for the respective Debtor entities, consented to so act, actually acted in such capacity, and did not assume the risk of loss for nonpayment by the end-user.

32. Under the B&C Agreement, all of the elements are present to create an agency relationship between Verizon and VarTec. The first element is present in the B&C Agreement as such agreement states that “[a]s a billing agent VERIZON is billing VARTEC’s revenues for a specific fee. VERIZON shall not report these billings as its own receipts for gross receipts Tax purposes or any other Tax purpose, unless otherwise required by Applicable Law.” See B&C Agreement, § 5.2, p. 45. The second element is present in the B&C Agreement because Verizon accepted the contract as represented by its signature to the B&C Agreement. The third element is present as well because VarTec has the right, for example, to seek changes to Verizon’s billing system. See B&C Agreement, § 38.1, p. 19. Additionally, control can be demonstrated by who bears the risk of loss in the B&C Agreement. VarTec bears the risk of loss. If VarTec’s end-user customers failed to pay their bills, then Verizon could setoff that bad debt from VarTec under the B&C Agreement (but only under the B&C Agreement). See B&C Agreement, Verizon Billing Procedures, § 13, p. 53.

33. Verizon acted as a billing and collection agent for certain Debtors, billing and collecting revenues for a specific fee. Verizon is now attempting to wrongfully set off amounts owed to it, wholly outside of its agency role, such as for interconnection and

facilities fees -- under the wholly unrelated Network Services Agreements -- against the amounts Verizon owes in its agency capacity under the B&C Agreement. Verizon cannot overcome the hurdle of capacity mutuality under 11 U.S.C. § 553 to make any attempted exercise of such a setoff proper.

**E. Verizon has a limited right to setoff amounts that VarTec owes under the B&C Agreement.**

34. Under the B&C Agreement, VarTec owes certain fees to Verizon as a collection fee payable under the B&C Agreement. The limited fees that VarTec agrees are subject to setoff are only those fees that arise under the B&C Agreement and not under any other agreements that a particular Debtor may have with Verizon. 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.

**PRAYER**

The Debtors respectfully request that the Court enter an order (i) determining the existence, if any, and the extent of Verizon's setoff rights consistent herewith; (ii) requiring the turn over of the Withheld Funds to the Debtors' estates; and (iii) granting such other and further relief to which they may be justly entitled.

Dated: June 28, 2005

Respectfully submitted,

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**ATTORNEYS FOR THE DEBTORS**

**CERTIFICATE OF SERVICE**

This is to certify that on June 28, 2005, a copy of the foregoing document was served by the Electronic Case Filing System for the United States Bankruptcy Court for the Northern District of Texas. A separate certificate of service shall be filed with respect to those parties on the Clerk's list who do not receive electronic e-mail service.

/s/ Holly J. Warrington

One of Counsel

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