

Daniel C. Stewart, SBT #19206500
William L. Wallander, SBT #20780750
Richard H. London, SBT #24032678
VINSON & ELKINS L.L.P.
3700 Trammell Crow Center
2001 Ross Avenue
Dallas, Texas 75201-2975
Tel: 214-661-7299
Fax: 214-220-7716
VarTec@velaw.com

PROPOSED ATTORNEYS FOR THE DEBTORS

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

IN RE:	§	
	§	
VARTEC TELECOM, INC., et al.,	§	CASE NO. 04-81694-SAF-11
	§	
DEBTORS.	§	(Chapter 11)
	§	(Joint Administration Requested)

**EXPEDITED MOTION TO CONFIRM AUTHORITY TO
PAY PREPETITION SALES, USE AND OTHER TAXES**

TO THE HONORABLE UNITED STATES BANKRUPTCY JUDGE:

The above-referenced debtors and debtors in possession (collectively, the “Debtors”)¹ file this Expedited Motion to Confirm Authority to Pay Prepetition Sales, Use and Other Taxes (the “Motion”) and in support would respectfully show the Court as follows:

JURISDICTION AND PROCEDURAL BACKGROUND

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

¹ 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.

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. Contemporaneously with the filing of this Motion, the Debtors filed their Expedited Motion for Joint Administration of Cases.

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 eighteen non-debtor direct and indirect foreign subsidiaries (collectively, the "VarTec Entities"), is among the largest privately held companies providing telecommunications services in North America and Europe. The VarTec Entities, founded in DeSoto, Texas in February 1989, with current employees totaling over 1,300 worldwide (including approximately 1,000 in the Dallas metroplex), 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 anticipate 2004 revenue in the approximate amount of \$900,000,000. VarTec's revenues have 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 markets 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 is managed by Excelcom, Inc. and certain of its subsidiaries (collectively, "Excel"), Excel offers 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, has an international network of over 130,000 independent representatives who market Excel's products and services to small business and residential consumers and recruit new independent representatives to market such products and services. Each independent representative receives commissions and bonuses based on, among other things, the success of the independent representatives recruited and a portion of the success of their recruits (referred to as a "downline"), the usage of Excel products and services by customers of the independent representative and a portion of their downline.

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 (the "Pre-Petition Loan 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.² 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 total outstanding obligation to the RTFC consist 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 FCC and various state agencies or public utility commissions. As consideration for relinquishing their monopoly positions, the ILECs were authorized to offer long distance telecommunications services, both out-of-region and in-region (where they were an ILEC) provided certain terms and conditions were satisfied.

² The capital stock of VarTec Telecom of Virginia, Inc. and Excel Telecommunications of Virginia, Inc. was pledged to the Rural Telephone Finance Cooperative under transactions completed in conjunction with the Credit Agreement.

13. ILECs, CLECs, and long distance carriers utilize each other's networks to transmit the voice and data traffic of their customers. The framework and pricing of the exchange of voice and data traffic between ILECs and CLECs, on the one hand, and long distance carriers, on the other hand, is governed by multiple laws, regulations, tariffs, and interconnection agreements. For example, if an ILEC or a CLEC's customer originates a call that is carried to its destination by one of the Debtors, the respective Debtor will bill the CLEC or ILEC on a minute of use basis; if a customer of one of the Debtors originates a call that is carried to its destination by an ILEC or a CLEC, the ILEC or CLEC will bill the respective Debtor on a minute of use basis. This is known as reciprocated or intercarrier compensation.³

14. To effectuate the billing, collection, and maintenance of account information, the Debtors often entered into agreements with various ILEC and CLEC, under which such ILEC or CLEC bills customers for the services provided by the Debtors, collects the billed amount for the Debtors, and pays or remits to the Debtors the collected amounts periodically.

15. The deregulation of local and long distance telecommunication services pursuant to the Telecommunications Act resulted in increased competition and decreased local and long distance rates. Despite successfully competing in the telecommunications industry for almost fifteen years, (i) VarTec's lack of brand name recognition comparable to some of its competitors in the more intensively competitive telecommunications market, (ii) customer attrition exacerbated by aggressive customer win-back campaigns by the dominant telco providers, and (iii) the margin compromises

³ A long distance carrier can also be an ILEC or a CLEC.

caused by increasing wholesale rates while retail rates are suffering, have all made it difficult for VarTec to maintain its historical revenue and profitability levels.

Challenges

16. In the weeks preceding the Petition Date, several ILECs, CLECs, and long distance carriers with whom the Debtors have interconnection or access agreements have (i) threatened to terminate services provided to the Debtors, (ii) requested security deposits, and/or (iii) offset amounts owed to the Debtors. The actions of the ILECs, CLECs, and long distance carriers have impaired the Debtors' liquidity.

17. In addition to the matters discussed above, because of various disputes⁴ with Teleglobe Inc. ("Teleglobe") regarding VarTec's acquisition of certain of the companies now associated with Excel and VarTec Solutions (the "Acquired Companies"), VarTec has had to spend millions of dollars in the past several years supporting the Excel companies (for which it had anticipated reimbursement), which has financially weakened the Debtors.

18. The combination of these economic and financial events has impaired the Debtors' liquidity and compelled the Debtors to commence these Cases in order to maximize the value of their assets for the benefit of their creditors and other constituencies under chapter 11 of the Bankruptcy Code.

RELIEF REQUESTED

19. By this Motion, the Debtors seek entry of an Order under Bankruptcy Code §§ 105(a), 363 and 541 authorizing, but not directing, them to pay prepetition federal, state, and local sales, use, and 911 taxes (the "Sales and Use Taxes"); state

⁴ Such disputes have spawned considerable litigation, including an arbitration between VarTec and Teleglobe's bankruptcy estate.

and local ad valorem taxes (the “Ad Valorem Taxes”); telecommunications relay service fees (“TRS Fees”); public utility commission fees (“PUC Fees”); federal and state universal service fund fees (“USF Fees”); and other fees and taxes (collectively, the “Taxes”) to the respective taxing authorities (the “Taxing Authorities”) in the ordinary course of the Debtors’ businesses.⁵ Such relief shall be without prejudice to the Debtors’ rights to contest the amounts of any Taxes on any grounds they deem appropriate. Further, the Debtors seek entry of an order authorizing, but not directing, them to pay prepetition Taxes for which the applicable payment had not cleared the Debtors’ bank accounts as of the Petition Date.

20. In the ordinary course of their businesses, and as part of their operations, the Debtors incur or collect various Taxes, including, but not limited to, Sales and Use Taxes, Ad Valorem Taxes, TRS Fees, PUC Fees, and USF Fees.

21. Certain Taxing Authorities require the Debtors to collect from their customers and remit to the Taxing Authorities Sales and Use Taxes that generally are based on a percentage of usage billed or collected for international, interstate, and intrastate telecommunication services. In most cases, the Sales and Use Taxes are paid to the Taxing Authorities monthly or quarterly in arrears once collected. As of October 31, 2004, the Debtors estimate that they have collected Sales and Use Taxes in the aggregate amount of at least \$4,260,809 that has not been paid, and will be payable, to the Taxing Authorities. A table summarizing the estimated Sales and Use Taxes by Debtor follows:

⁵ The Debtors do not request authority to pay employment taxes to Taxing Authorities in this Motion. That relief is requested in the Debtors’ Expedited Motion to Approve Payment of Prepetition Wages, Salaries, Commissions, Reimbursable Employee Expenses and Benefits in the Ordinary Course of Business (Employees) filed on the date of the filing of this Motion.

Debtor	Estimated Amount of Sales and Use Tax
VarTec Telecom, Inc.	\$2,956,021
VarTec Telecom of Virginia, Inc.	\$121,500
Excel Communications Marketing, Inc.	\$7,651
Excel Products, Inc.	\$100
Excel Telecommunications, Inc.	\$1,163,537
Excel Telecommunications of Virginia, Inc.	\$12,000

22. Ad Valorem Taxes are assessed and become payable in the ordinary course of business and are calculated based on a statutorily mandated percentage of property value (for both real and personal property). Generally, Ad Valorem Taxes are due annually; the timing of the payment of Ad Valorem Taxes varies from jurisdiction to jurisdiction. As of October 31, 2004, the Debtors estimate that they have accrued Ad Valorem Taxes that are not yet due to the Taxing Authorities in the aggregate amount of at least \$2,203,332. A table summarizing the estimated Ad Valorem Taxes by Debtor follows:

Debtor	Estimated Amount of Ad Valorem Tax
VarTec Telecom, Inc.	\$794,027
VarTec Properties, Inc.	\$212,642
Excel Management Services, Inc.	\$32,792
Excel Products, Inc.	\$1,502
Excel Teleservices, Inc.	\$51,720
Excel Telecommunications, Inc.	\$138,386
VarTec Solutions, Inc.	\$77,158
Telco Network Services, Inc.	\$895,105

23. TRS Fees and PUC Fees are assessed and become payable in the ordinary course of business. TRS Fees generally are calculated based on the number of telephone lines used within a jurisdiction, and PUC Fees generally are calculated based on a percentage of revenue. TRS Fees are used by the Taxing Authorities to subsidize the cost of certain services, including telephone service for deaf individuals,

and PUC Fees are used by the Tax Authorities to fund state regulatory operations and otherwise raise revenue for a jurisdiction. Generally, TRS Fees are paid on a monthly basis in arrears, and PUC Fees are paid quarterly, semi-annually, or annually in arrears. As of October 31, 2004, the Debtors estimate that they have accrued TRS Fees and PUC Fees that have not been paid, and will be payable, to the Taxing Authorities in the aggregate amount of at least \$485,459. A table summarizing the estimated TRS Fees and PUC Fees by Debtor follows:

Debtor	Estimated Amount of TRS Fees and PUC Fees
VarTec Telecom, Inc.	\$287,738
Excel Telecommunications, Inc.	\$176,826
VarTec Solutions, Inc.	\$20,895

24. USF Fees are assessed and become payable in the ordinary course of business and generally are calculated based on a percentage of revenue. Generally, USF Fees are due monthly in arrears. USF Fees are used by Tax Authorities to subsidize (i) the cost of telephone services provided to rural and other high cost areas and (ii) schools, libraries, and rural healthcare providers. As of October 31, 2004, the Debtors estimate that they have accrued USF Fees that have not been paid, and will be payable, to the Taxing Authorities in the aggregate amount of at least \$1,325,125. A table summarizing the estimated USF Fees by Debtor follows:

Debtor	Estimated Amount of USF Fees
VarTec Telecom, Inc.	\$709,686
Excel Telecommunications, Inc.	\$609,361
VarTec Solutions, Inc.	\$6,078

25. The Debtors also pay a variety of other Taxes, including payments relating to franchise taxes, gross receipts taxes, rights of use, and poison control surcharges.

Although the Debtors are subject to federal and state income taxes, they estimate that they will not have liability for such taxes due to their financial condition.

26. Because of the costs that would be involved and because the Debtors believe that there exist multiple legal bases for granting the relief requested herein, the Debtors have not conducted an exhaustive survey of all states in which the Taxes are due to determine whether such taxes are deemed “trust fund” taxes in each jurisdiction. Nevertheless, the Debtors submit that many of the Taxes likely constitute “trust fund” taxes which are required to be collected from third parties and held in trust for payment to the Taxing Authorities. See e.g., *Begier v. Internal Revenue Service*, 496 U.S. 53 (1990); *In re Megafoods Stores, Inc.*, 163 F.3d 1063, 1067-68 (9th Cir. 1998); *City of Farrell v. Sharon Steel Corp.*, 41 F.3d 92, 97 (3rd Cir. 1994) (holding that income required to be withheld by city ordinance and state law is held “in trust” for the taxing authority); *In re Al Copeland Enterprises, Inc.*, 991 F.2d 233, 237 (5th Cir. 1993); *In re Equalnet Communications Corp.*, 258 B.R. 368, 370 (Bankr. S.D. Tex. 2000) (“[C]ertain prepetition tax claims, such as sales taxes, could be trust fund claims.”); Lawrence P. King, ed. 5 COLLIER ON BANKRUPTCY ¶ 541.11[4] (2004); see also *In re Shank*, 792 F.2d 829 (9th Cir. 1986) (Bankruptcy Code’s “trust fund” tax provisions, not “excise” tax provisions, govern priority and dischargeability of creditor claims for sales taxes required by state law to be collected by sellers from their customers).

27. To the extent that “trust fund” taxes are collected, they are not property of the estates under Bankruptcy Code § 541(d). See *Begier v. I.R.S.*, 496 U.S. 53 (1990); *In re Al Copeland Enterprises, Inc.*, 133 B.R. 837 (Bankr. W.D. Tex. 1991). Therefore,

the Debtors would have no equitable interest in those Taxes which would be deemed “trust fund” taxes.

28. In many states, laws provide that the officers and directors of the collecting entity may be held personally liable for the payment of Taxes to the Taxing Authorities. To the extent any accrued Taxes of the Debtors were unpaid as of the Petition Date, the Debtors’ officers and directors may be subject to lawsuits during the pendency of these Cases. Such lawsuits would prove extremely distracting to the Debtors, the officers and directors, and this Court (which might be asked to entertain various motions seeking injunctions relating to the potential state court actions). It is in the best interest of the Debtors’ estates to eliminate the possibility of such time-consuming and potentially damaging distractions.

29. Even if the Taxes are not “trust fund” taxes, payment of such Taxes would be authorized pursuant to Bankruptcy Code § 105(a). This section provides, “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a). The purpose of section 105(a) is to “assure the Bankruptcy Court’s power to take whatever action is appropriate or necessary in aid of the exercise of its jurisdiction.” 2 COLLIER ON BANKRUPTCY 105.01 (15th ed. 2004). Bankruptcy Code § 105(a) essentially codifies the bankruptcy court’s inherent equitable powers. See *Mgmt. Tech. Corp. v. Pardo*, 56 B.R. 337, 339 (Bankr. D. N.J. 1985).

30. Utilizing the doctrine of necessity, a bankruptcy court may authorize a debtor to pay prepetition taxes that are necessary to effect a successful reorganization. See *In re Lehigh & New England Ry. Co.*, 657 F.2d 570, 581 (3d Cir. 1981); *In re Penn*

Central Trans. Co., 467 F.2d 100, 102 (3d Cir. 1973); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989).⁶

31. That the payment of the Taxes is necessary to avoid potential administrative difficulties is unquestionable. If the Taxes were not paid, Taxing Authorities likely would take precipitous action, including a marked increase in state audits and a flurry of lien filings or lift stay motions. Only the prompt and regular payment of the Taxes will avoid these unnecessary governmental actions.

32. Finally, most, if not all, of the Taxes are entitled to priority status pursuant to Bankruptcy Code § 507(a)(8). The Debtors' payment of the Taxes now, in all likelihood, would only affect the timing of the payments and would reduce the amount of Taxes owed if later paid under a plan of reorganization (due to the high interest rates and late fees attributable to delinquent tax payments). Therefore, other creditors and parties in interest would not be prejudiced if the relief sought herein were granted by this Court.

33. Numerous bankruptcy courts have authorized debtors to pay prepetition tax obligations. See, e.g., *In re Daisytek, Incorporated, et al.*, Case No. 03-34762, Docket No. 55 (Bankr. N.D. Tex. May 12, 2003); *In re Mosaic Group (US) Inc., et al.*, Case No. 02-81440, Docket No. 76 (Bankr. N.D. Tex. Dec. 27, 2002); *In re Global Crossing Ltd.*, Case No. 02-40188, Docket No. 37 (Bankr. S.D.N.Y. Jan. 30, 2002); *In re*

⁶ Although the "necessity of payment" doctrine has been widely accepted, the Court in *In re CoServ, L.L.C.*, 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002) developed an alternative test to determine whether payment of certain prepetition unsecured claims prior to confirmation of a plan of reorganization would be appropriate. Under the *CoServ* test, a debtor must show (i) it is critical that the debtor deal with the claimant; (ii) unless the debtor deals with the claimant, the debtor risks the probability of harm, or alternatively, loss of economic advantage to the estate of the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim; and (iii) that there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim. *Id.* Although the *CoServ* analysis appears to be applicable only to the treatment of prepetition vendor claims, the payment of the Taxes would satisfy the *CoServ* analysis, if applicable.

Worldcom, Inc., et al., Case No. 02-13533, Docket No. 66(Bankr. S.D.N.Y. Jul. 23, 2002).

Honoring Prepetition Checks and Electronic Transfers

34. The Debtors request that, to the extent of funds on deposit, all applicable banks and other financial institutions, including United Missouri Bank (Disbursement Account Nos. 5008009368 and 9871499251), shall be authorized to receive, process, honor and pay all checks presented for payment and to honor all funds transfer requests made by the Debtors relating to the Taxes, whether such checks were presented or fund transfer requests were submitted prior to, or subsequent to, the Petition Date. Further, the Debtors request authority to issue post-petition checks, or to effect post-petition transfer requests in replacement of any checks or fund transfer requests with respect to its Tax obligations dishonored or denied as a consequence of the commencement of the Cases.

Conclusion

35. For the foregoing reasons, the Debtors seek authorization, but not direction, to pay, perform or otherwise honor, any or all obligations with respect to Taxes and to pay those Taxes for which checks were issued but failed to clear the Debtors' bank accounts before the Petition Date. Nothing in this Motion is intended, nor should it be construed, to impair the Debtors' rights to contest the amount or basis of any Taxes that may be alleged to be due, and the Debtors expressly reserve all rights with respect thereto.

PRAYER

The Debtors respectfully request that the Court authorize the payment of the Taxes and grant them such other and further relief to which they may be justly entitled.

Respectfully submitted,

VINSON & ELKINS L.L.P.

2001 Ross Avenue
3700 Trammell Crow Center
Dallas, Texas 75201
Tel: 214-661-7299
Fax: 214-220-7716

By: /s/ Daniel C. Stewart (11/01/04)
Daniel C. Stewart, SBT #19206500
William L. Wallander, SBT #20780750
Richard H. London, SBT #24032678

**PROPOSED ATTORNEYS FOR
THE DEBTORS**

828292_4.DOC