James E. Spiotto [Admitted *Pro Hac Vice*]
Chapman and Cutler
111 West Monroe Street
Chicago, IL 60603-4080
Telephone: (312) 845-3000
Facsimile: (312) 701-2361

William R. Pascoe, Esq. (State Bar #54284)
Pascoe & Rafton
1050 Northgate Drive
Suite 356
San Rafael, CA 94903
Telephone: (415) 492-1003
Facsimile: (415) 492-3312

ATTORNEYS FOR SENIOR DEBTHOLDERS

50-995/323

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

IN RE:	)
	)
PACIFIC GAS AND ELECTRIC COMPANY, a California corporation,	) Case No. 01-30923 DM
	) Chapter 11 Case
	) Date: March 25, 2002
	) Time: 9:30 a.m.
	) Place: 235 Pine Street, San Francisco, California
Debtor.	)

SENIOR DEBTHOLDERS' STATEMENT IN SUPPORT OF PACIFIC GAS AND ELECTRIC COMPANY'S MOTION FOR ORDER (A) APPROVING SETTLEMENT AND SUPPORT AGREEMENT BY AND AMONG PLAN PROPONENTS AND SENIOR DEBTHOLDERS, (B) AUTHORIZING PAYMENT OF PRE- AND POST-PETITION INTEREST TO HOLDERS OF UNDISPUTED CLAIMS IN CERTAIN CLASSES, (C) AUTHORIZING PAYMENT OF FEES AND EXPENSES OF INDENTURE TRUSTEES AND PAYING AGENTS AND (D) AUTHORIZING DEBTOR TO ENTER INTO SIMILAR SETTLEMENTS AND SUPPORTING MEMORANDUM OF POINTS AND AUTHORITIES

A001 Add: Kids Age Mail Center

1332766.01.16

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

STATUTES

OTHER AUTHORITIES

NOW COME the Senior Debtholders[1] and submit this Statement in Support of Pacific Gas and Electric Company's Motion for Order (A) Approving Settlement and Support Agreement By and Among Plan Proponents and Senior Debtholders, (B) Authorizing Payment of Pre- and Post-Petition interest to Holders of Undisputed Claims in Certain Classes, (C) Authorizing Payment of Fees and Expenses of Indenture Trustees and Paying Agents and (D) Authorizing Debtor to Enter into Similar Settlements and Supporting Memorandum of Points and Authorities (the "*Motion*"), and, in support thereof, respectfully state as follows:

I. INTRODUCTION

The Motion filed by the Proponents[2] on March 5, 2002, in and of itself, provides ample justification for the approval of the Settlement Agreement by the Bankruptcy Court and the authorization of pre-confirmation interest payments to Senior Debtholders. In addition to the persuasive arguments set forth by the Debtor in the Motion, the Senior Debtholders submit this Statement of Support to provide additional grounds for the approval of the Settlement Agreement, including the long-term importance to the Debtor that the capital markets perceive the Debtor as a reliable borrower who abides by its contractual commitments.

The Senior Debtholders, taken together, hold over $2.0 billion in principal amount of unsecured claims against the Debtor. As such, they represent a significant percentage of the unsecured claims in this case. Furthermore, the Senior Debtholders' claims consist of financial

---

1 The "Senior Debtholders" refers to the following separate entities: State Teachers Retirement System of Ohio; DC Water and Sewer Authority; Chandler Asset Management; Franklin Mutual Advisers,, LLC; King Street Capital; M.H. Davidson & Co., L.L.C.,; OZF Management L.P.; OZ Management, L.L.C.; Pacific Investment Management Company, L.L.C.; Satellite Asset Management L.P.; Security Benefit Life Insurance Co.; Stark Investments; Angelo Gordon & Co.; the State of Tennessee; Appaloosa Management LP; Deutsche Banc Alex. Brown, Inc.; Bankers Trust Company; Halcyon Offshore Management Company LLC; and Halcyon/Alan B. Slifka Management Company LLC. The position set forth in this Statement of Support represents the individual views of each of the Senior Debtholders.

2 Unless otherwise defined herein, all capitalized terms not defined herein shall have the same meaning ascribed to them in the Motion, Settlement Agreement or in the Second Amended Plan of Reorganization proposed by the Debtor and PG&E Corporation.

debt arising from the Debtor's pre-petition request for the support of the capital markets to finance its ongoing operation. The Senior Debtholders hold, among other things, Commercial Paper Claims, Floating Rate Note Claims, Medium-Term Note Claims, Senior Note Claims and Revolving Line of Credit Claims, all of which were issued and purchased by capital market participants with the understanding that such participants were acquiring investment grade securities issued by a financially-sound utility, generally regarded as one of the safest investments. A large portion of the pre-petition capital market financing was extended during the recent "energy crisis" in California, and such financing enabled the Debtor to generate and distribute electricity to California ratepayers at a time when the Debtor was bleeding cash. As set forth in the attached declarations of certain of the Senior Debtholders[3], capital market participants, including governmental bodies and pension funds, extended pre-petition credit to the Debtor with the expectation that there was no significant payment risk and in reliance upon the scheduled payment of interest to meet their investment goals as represented by the Debtor and approved by the California Public Utilities Commission (the "*CPUC*"). The capital markets, including the Senior Debtholders, have reacted adversely to the Debtor, a solvent entity, filing bankruptcy and the resulting cessation in interest payments. If no steps are taken by the Debtor to ameliorate the problem, the Debtor could pay a heavy price for borrowed funds post-confirmation.

In order to have access to the capital markets, a borrower must be creditworthy and have credibility. To achieve both, a borrower must demonstrate a history of performance, must be perceived in the market place as an obligor who will timely meet its debt obligations and must provide assurance that market participants will not suffer a loss because of the borrower's

---

3 Filed in furtherance of this Statement of Support are the declarations of representatives of the State of Tennessee ("*Tennessee*"), State Teachers Retirement System of Ohio ("*STRS Ohio*"), Pacific Investment Management Company, LLC ("*PIMCO*") and the District of Columbia Water and Sewer Authority ("*DCWASA*").

aggressive business or financial tactics. Upon emergence from bankruptcy, the Debtor will need to look to capital market participants, including not only the rating agencies who rate the Debtor's securities, but also the traditional capital market purchasers of utility debt, to finance its operation going forward. The Senior Debtholders respectfully submit that approval of the Settlement Agreement is key to the rehabilitation of the Debtor in the capital markets and will reduce the price the Debtor will pay for exit financing.

The Settlement Agreement is the culmination of months of good-faith, arms-length negotiations between the Debtor and the capital market participants who are the Senior Debtholders. An integral component of the Settlement Agreement is the payment of interest to the Senior Debtholders during the pendency of the bankruptcy proceeding. Such payments, clearly proper under the Bankruptcy Code, will benefit the Debtor in two ways. First, the interest payments fulfill the reasonable expectations of the capital market participants, thereby restoring the Debtor's credibility with the capital markets and helping ensure the availability and affordability of financing for the Debtor in the future. The treatment of the Senior Debtholders as provided in the Settlement Agreement will help enhance the credit rating of the Debtor and will restore the capital market's confidence in the Debtor's securities as suitable investment vehicles. Second, as explained in the Motion, the ongoing payment of interest alleviates the expenses attributable to a negative arbitrage environment triggered by interest accruing at rates significantly higher than rates the Debtor can obtain for temporary short term investments. This accumulating overdue interest would eventually be incurred by the Debtor because of the Debtor's solvency.

As more fully explained in the Motion and supported below, the Settlement Agreement is fair, equitable and in the best interests of creditors and the Estate because the agreement eliminates the risks and costs associated with drawn-out litigation and because the Settlement Agreement will be a positive step in ensuring that capital market financing, a necessity for the continued financial viability of the Debtor, will be available and affordable to the Debtor in the future.

II. Background

As the court is well aware, the Debtor filed its petition for bankruptcy relief under Chapter 11 of the Bankruptcy Code on April 6, 2001. On September 20, 2001, the Debtor and the Parent filed the Plan of Reorganization. The Senior Debtholders, through counsel, quickly voiced to the Debtor their objections to the Plan and the Disclosure Statement. On November 27, 2001, the Senior Debtholders filed an objection to the Disclosure Statement (the "*Disclosure Statement Objection*") which challenged the confirmability of the Plan and the adequacy of the Debtor's disclosures in the Disclosure Statement. Notwithstanding the filing of the Disclosure Statement Objection, negotiations between the Debtor and the Senior Debtholders continued. On December 19, 2001, the Debtor filed its First Amended Plan and First Amended Disclosure Statement. Following such filing, the Senior Debtholders continued to negotiate with the Debtor and, in order to preserve their rights, on January 10, 2002, filed an objection to the First Amended Disclosure Statement (the *"Amended Disclosure Statement Objection"*). Finally, after months of discussion and negotiation, shortly after filing the Amended Disclosure Statement Objection, the Senior Debtholders and the Plan Proponents reached a settlement regarding the treatment of Senior Indebtedness. This settlement was later memorialized in a stipulation and term sheet filed with the Bankruptcy Court on January 14, 2002 and is more fully set forth in the Settlement Agreement attached to the Motion as Exhibit A.

In summary, the Settlement Agreement provides that the Debtor will fix the amount of the Senior Debtholders' claims, pay accrued and unpaid interest on those claims at the agreed-upon contract rate on an ongoing basis prior to confirmation and will make certain amendments to the Plan then on file after the Settlement Agreement becomes effective. Such amendments include the modification of certain terms of the Long Term Notes to enhance their market value and transferability. Moreover, the Settlement Agreement provides that, subject to the Court's approval, the Debtor will pay the reasonable fees and expenses of the Senior Debtholders. Further, if exit from Chapter 11 does not occur by February 2003 (a goal generally accepted by all Plan Proponents), or further delays occur thereafter, there are certain stepped-up rates in order to compensate for that delay. The effect of the Settlement Agreement by this solvent Debtor should be to place the capital market claimants in the position they bargained for pre-petition. In exchange for these concessions by the Debtor, the Senior Debtholders have agreed upon the Settlement Agreement becoming effective, among other things, to support confirmation of the Plan, to withdraw their objections to the proposed treatment of the QUIDS that are contractually subordinated to the Senior Indebtedness and, subject to various conditions, to vote their claims in favor of the Plan.

III. DISCUSSION

Standing alone, the Motion provides ample grounds for the approval of the Settlement Agreement and the authorization of pre-confirmation payments to Senior Debtholders. In addition to the sound arguments advanced in the Motion, the Senior Debtholders wish to emphasize the importance of the approval of the Settlement Agreement from the perspective of the capital markets. The Senior Debtholders cannot emphasize strongly enough how essential it is that the capital markets re-establish a positive perception of the Debtor. Only if the Debtor's reputation and credibility in the capital markets are restored, can the Debtor hope to reorganize successfully and enjoy continuing post-confirmation vitality.

A. The Settlement Agreement Should be Approved by the Court

The Settlement Agreement should be approved by the Court because it is in the best interests of the creditors and is necessary to the effective reorganization of the Debtor. The Settlement Agreement honors the pre-petition obligations the Debtor owes its capital market lenders and helps to ensure continued support of the Debtor by the capital markets.

As set forth in the Motion, Bankruptcy Rule 9019(a) authorizes a bankruptcy court to approve any settlement or compromise related to a reorganization or litigation. FED. R. BANKR. P. 9019(a). In deciding whether a settlement agreement should be approved, the court should analyze whether the compromise is fair and equitable and in the best interests of the Estate. *See Martin v. Kane (In re A & C Props.)*, 784 F.2d 1377, 1380-81 (9th Cir. 1986). In *A & C Properties*, the Ninth Circuit set forth four criteria to determine whether a proposed settlement is reasonable and in the best interests of creditors. These factors include: (1) the probability of success on the merits; (2) the difficulties, if any, to be encountered in the matter of collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors and a proper deference to their reasonable views. *See A & C Props.*, 784 F.2d at 1381. As demonstrated effectively in the Motion, the *A & C Props.* requirements are fulfilled. Without question, the dispute involves complex, and to some extent, novel areas of the law that would require much time and expense to resolve. As with most litigation, a successful outcome for either party is not assured. Furthermore, as explained below, approval of the Settlement Agreement is in the best interests of the Debtor's Estate and the creditors because, among other reasons, the support of the capital markets is necessary for the reorganization and future prospects of the Debtor.

As the Court is no doubt aware, the Debtor and, in a larger sense, the entire public utility industry, relies heavily on the debt financing provided by the capital markets. Typical investors in the securities of utilities include governmental bodies and pension funds that require predictable and guaranteed returns. (See Declarations of Tennessee, ¶6; STRS Ohio, ¶4; DCWASA ¶4; and PIMCO, ¶4.) Utilities in turn are especially dependent upon the capital markets due to the continuing need to fund necessary capital improvements for the transmission, generation and distribution of electricity. The availability and affordability of capital market financing is directly influenced by the way rating agencies and the capital markets themselves view the Debtor.

The Debtor has utilized the capital markets to finance many projects, improvements and other capital needs. Significantly, during the energy crisis of 2000, the Debtor was permitted to issue over $2 billion in debt in order to finance its business operations. The CPUC, recognizing the necessity of an injection of capital to reduce the then-current cost of electricity to ratepayers, authorized the issuance by the Debtor of short-term debt in the form of these new securities: Commercial Paper, Floating Rate Notes, Five-Year Notes and Bank Debt. The incurrence of this debt was specifically approved, not only by the Debtor's Board of Directors, but by the CPUC, as a reasonable cost of the Debtor, and therefore an appropriate part of the rate base. *See In the Matter of the Application of Pacific Gas & Electric for an Expedited Order Modifying Decision No.* 87-09-056 (Application No. 87-08-008), Decision No. 00-10-065 (Oct. 19, 2000). The inclusion of this capital market financing in the rate base was a matter of public record and, in effect, meant that there was a source of payment for the debt instruments. It strengthened the position that the purchase of such investment grade instruments was prudent and reasonable because there was an adequate assurance of repayment. As set forth in the attached Declarations, such representations were relied upon by the capital market participants, who believed they were purchasing securities that had the support of the CPUC and that would supply interest at the agreed-upon rate until the securities were repaid. (See Declarations of Tennessee, ¶8; STRS Ohio, ¶8; DCWASA ¶8; and PIMCO, ¶8.)[4]

Based on such reliance, capital market participants purchased the securities with the full expectation that they would be paid upon maturity (including the Commercial Paper investors

4 Moreover, the Debtor indicated in its 10Q for the Quarterly Period ending September 30, 2000, that a revolving credit facility was in place to provide commercial paper back-up. It also reported that the CPUC had authorized the Debtor to increase its short-term borrowing authority from $1.4 billion to $3.1. billion. (See Declaration of STRS Ohio, ¶8.)

who anticipated repayment in 90 days or less and the holders of approximately $1.2 billion of Floating Rate Notes that matured within one year) and that the interest payments would be made on a normal and regular basis pursuant to the express terms and conditions of each debt instrument. Certain of the problems that have arisen for creditors because of the Debtor's failure to pay are described in the attached Declarations. For instance, STRS Ohio purchased $56 million of Commercial Paper issued by the Debtor with the expectation that repayment would be available in less than 90 days, which would contribute to the liquidity reserves of its portfolio. (See Declaration of STRS Ohio, ¶10.) Likewise, the State of Tennessee and the District of Columbia Water and Sewer Authority each purchased these investment-grade securities (A1-P1 paper, the highest rating) for short term investment, being assured that they would be repaid in a short period of time. (See Declarations of Tennessee, ¶¶4 and 8; DCWASA, ¶¶4 and 10.) Obviously, given the Debtor's financial crisis in early 2001 and bankruptcy filing, no repayment occurred. Thus, after investing their money to help the State of California, the CPUC and the Debtor deal with their energy crisis, these investors were required to find ways of dealing with the lack of funds. Due to the Debtor's defaults and bankruptcy filing, significant injury has been incurred by the capital market participants, including the Senior Debtholders, and the financial credibility of the Debtor has been damaged.[5]

The Settlement Agreement is a significant attempt to repair the damage caused by the Debtor's bankruptcy and cessation of contracted-for payments. The Settlement Agreement attempts to reestablish agreed-upon contract rates consistent with the issuing documents, the

---

5 In some cases, the default and non-payment of the Debtor rendered Senior Debtholders out of compliance with applicable investment policy. The State Pool of Tennessee is restricted to short-term investments; the maximum maturity of any security in the State Pool cannot exceed 367 days, and the weighted average maturity of all securities must be 90 days or less. (Declaration of Tennessee, ¶4.) Similarly, under its Cash Management and Investment Policy, permissible investments for commercial paper for the DCWASA cannot exceed 180 days. (Declaration of DCWASA, ¶4). Further, because of PG&E's default on the Commercial Paper, the State Pool of Tennessee was not able to show its investment in the Commercial Paper as a cash asset of the State's general fund, reducing thereby the funds available for State programs. (Declaration of Tennessee, ¶9).

understanding of the parties and applicable law. In doing so, the Settlement Agreement attempts to rehabilitate the Debtor's credibility with the capital markets. Such renewed credibility will be of benefit to the Debtor regardless of what plan ultimately is confirmed because the Debtor will, without question, require capital market financing upon emerging from bankruptcy protection. Renewed confidence will inure to the benefit of the Debtor and all creditors by helping to ensure that long-term borrowings of the Debtor will be accepted by the capital markets and that the costs of such borrowings will be comparable to creditworthy investment-grade borrowers. Unreasonable treatment of the capital markets renders the cost and availability of such financing uncertain at best. Thus, the Settlement Agreement is a necessary component to the reorganization and continued financial vitality of the Debtor.

B. The Settlement Agreement Provisions Regarding Current Payments of Interest to Current Holders of Undisputed Claims Should be Authorized

In the Settlement Agreement, the Debtor agreed to pay all accrued and unpaid pre-petition and post-petition interest to the holders of undisputed claims, including the Senior Debtholders, and to continue to pay post-petition interest in arrears during the Chapter 11 Case. Such interest payments (1) are necessary to the effective reorganization of the Debtor and its continued financial viability; and (2) are proper under the Bankruptcy Code.

First, as mentioned in the Motion, the payment of interest during the pendency of this bankruptcy proceeding is necessary to the effective reorganization of the Debtor. In order to comply with the best interests of creditors test under §1129(a)(7) of the Bankruptcy Code, the Debtor, because it is admittedly solvent, must pay post-petition interest to its creditors. *See Commercial Paper Holders v. R.W. Hine (In re Beverly Hills Bancorp)*, 752 F.2d 1334, 1339 (9th Cir. 1984)(court's denial of post-petition interest by solvent debtor was an abuse of discretion); *In re Dow Corning Corp.*, 244 B.R. 678, 686-87 (Bankr. E.D. Mich. 1999); *In re Schoeneberg*, 156 B.R. 963, 970 (Bankr. W.D. Tex. 1993). Absent court authorization, the

Debtor must continue to accrue the interest payments it is required to make to creditors until such time as it is allowed to make such payments. *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 314 (Bankr. W.D. Pa. 1990)(court allows post-petition interest which accrues on unsecured claims when debtor is solvent). As set forth in the Declaration of Kent M. Harvey filed on March 5, 2002, by the Debtor, the interest which would accrue on the Senior Indebtedness is higher than the interest which can be earned by the Debtor on its temporary investments in the open market. Thus, each day that the interest payable to creditors continues to accrue, the Debtor loses significant amounts of revenue which would otherwise be available for capital improvements or further debt service. The current payment of interest would eliminate this negative arbitrage.

Moreover, in this case, as previously mentioned, the support of the capital markets is necessary for the Debtor's reorganization and its future financial viability. Since the Debtor claims to be solvent and liquid (its latest financial reporting indicting over $4 billion in cash) and since there is negative arbitrage to any delay in repayment, it is prudent for the Debtor to build credibility by honoring its promises to the capital markets. All that the Settlement Agreement does is reaffirm the continuing obligation to make periodic payments on acknowledged debt, given the Debtor's ability based on liquidity and current projections. The Debtor's treatment of capital market participants in this Chapter 11 case will significantly affect the availability and overall cost of obtaining financing for the Debtor well into the Debtor's post-confirmation future. (See Declarations of Tennessee ¶12; STRS Ohio, ¶14; DCWASA, ¶14; and PIMCO ¶14.) Pre-confirmation payments of interest to the Senior Debtholders provide assurance to the capital market participants that the Debtor can be treated as a solvent utility credit and is a satisfactory risk. The capital markets can also fairly conclude that the Debtor will make all reasonable attempts to honor its pre-petition obligations for financing, which thereby helps ensure the availability of further financing at a competitive cost upon the Debtor's emergence from bankruptcy protection. The market will surely attach a price to any failure to pay current interest.

Furthermore, it is in the best interests of creditors to receive the prompt payment of interest on their claims.[6] It is unquestionably clear that creditors would benefit by receiving cash payments of interest now instead of waiting for such payments in the future. Such payments would begin to ameliorate the harm suffered by the creditors who provided financing to the Debtor when it was in crisis. Such payments would be available to all similarly-situated unsecured creditors. Moreover, because such payments are mandatory due to the Debtor's solvency, neither the Debtor's Estate nor other creditors are prejudiced by such payments.

Second, current payments of interest are proper under the Bankruptcy Code. Such payments have been explicitly permitted by the courts in numerous cases. For instance, in *In re Chateguay Corp*., 80 B.R. 279 (S.D.N.Y. 1987), the Southern District of New York held that the Bankruptcy Court maintained the authority to authorize pre-confirmation payments by the Debtor to some creditors in a class while not paying others. *Id.* at 286. In *Chateguay*, the Debtor sought to pay certain pre-petition wages, salaries and reimbursement expenses of employees. *Id.* at 285. The State of Michigan argued that such payments would violate §§507 and 1122 of the Bankruptcy Code. *Id.* at 286. The court found that such payments were proper. According to the court, a rigid application of the priorities of §507 would be inconsistent with the Act's grant of equity powers to bankruptcy courts and the fundamental purpose of reorganization, which is "to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately." *Id.* at 287. Thus, the court found that, although the payments to creditors treated disparately members of the same class, such treatment was justified under the circumstances. *Id.*; *see also* 9E AM. JUR. 2D *BANKRUPTCY*

---

6 The Settlement Agreement will also obviate the need for litigation over the contractual subordination of the QUIDS to Senior Indebtedness, which could prove expensive to the Estate and others.

§3034 (2000) (discussing same). The Settlement Agreement provides that, should the Debtor later be determined to be insolvent, the payments of interest can be recharacterized. Thus, there is no harm to the Estate to make the payments now.

The court should exercise its equitable powers and permit the pre-confirmation interest payments because such payments would not affect the treatment of other unsecured creditors under the First Amended Plan due to the Debtor's solvency. As the court is aware, the Debtor has continually asserted to the Court and to its creditors that it is solvent and that all creditors will be paid in full with interest. The solvency of the Debtor and the treatment of other creditors is a critical inquiry in determining whether pre-confirmation payments are appropriate. In *In re Structurelite Plastics Corp.* (*Structurelite II*), 91 B.R. 813, 816 (Bankr. S.D. Ohio 1988), the bankruptcy court found that pre-confirmation payments were proper where certain exigent circumstances were met and where other creditors would not be harmed by such payments. *Id.* at 815; *see also In re Structurelite Plastics Corp.* (*Structurelite I*), 86 B.R. 922, 929-31 (Bankr. S.D. Ohio 1988)(providing background of dispute). In *Structurelite II*, the Debtor sought the interim payment of certain prepetition medical benefit claims for employees. *Id.* The Court permitted such payments upon an initial showing by the Debtor that the payments were necessary to the reorganization of the Debtor. *Structurelite II,* 91 B.R. at 816. After finding that the payments were necessary, the court stated that the inquiry should look to whether authorizing the payment of the prepetition debt "creates the greatest likelihood of payment of creditors in full or at least proportionately." *Id.* at 815-16. The court applied this standard and found that the payments were proper. *Id.* Under the rationale set forth in *Structurelite I* and *II* and *Chateguay,* the court should find that the pre-confirmation interest payments are necessary and are permissible under the Bankruptcy Code because the Debtor is solvent, there is a great likelihood that the creditors will be paid in full and, absent payment, the Debtor will pay a significant price when it returns to the capital markets.

Integrating pre-confirmation payments into a settlement agreement is not a novel idea. In the recent *Covad Communications* bankruptcy proceeding, *In re Covad Communications Group, Inc.*, No. 01-10167 (Bankr. D. Del.), the Bankruptcy Court for the District of Delaware permitted the debtor to assume an agreement with certain noteholders which provided pre-confirmation payments to the noteholder if certain deadlines were not met by the debtor. In the *Covad* bankruptcy, the noteholders (representing 54% of the total principal amount of the notes) and the debtor executed an Agreement Concerning Voting (the *"ACV"*) prior to the petition date in order to assure that a plan of reorganization could be approved and implemented. Pursuant to the ACV, the noteholders agreed to support the plan of reorganization in exchange for a cash payment of $256.78 million (the *"ACV Funds"*) (approximately 19.1 cents on the dollar) and a 15% equity interest in the reorganized debtor. As provided in the ACV, the ACV Funds would be placed in an escrow account and could be distributed to the noteholders upon confirmation of the plan or could be distributed to the noteholders prior to confirmation if the Debtor should miss any of the various deadlines in the plan confirmation process (the *"Escrow Agreement"*). The Debtor moved under Section 365 of the Bankruptcy Code for an order authorizing the Debtor to assume the Escrow Agreement (the *"Escrow Agreement Motion"*). Over the strenuous objection of the U.S. Trustee and certain non-consenting noteholders, the Court ordered that the debtor could assume the Escrow Agreement. The Escrow Agreement Motion, Order, the Objection of the Trustee and the Objection of Certain Noteholders are attached as Exhibits A, B, C and D hereto.

As evident in *Covad* as well as in *Chateguay* and *Structurelite I* and *II*, under these circumstances, pre-confirmation payments are permitted by the Bankruptcy Code. The propriety of such payments in this case is particularly clear because the payments are necessary for the effective reorganization, with the assistance of the capital markets, of the Debtor, and for the continued vitality of the Debtor's business. Satisfaction of the capital markets in this case is akin to the payments of allowed claims to critical vendors in other bankruptcies. Moreover, the Debtor is solvent and has continually asserted that all unsecured creditors will be paid in full with interest. Therefore, the pre-confirmation payments should be permitted.

C. The Settlement Agreement Requires that the Senior Debtholders' Support the Debtor's Amended Plan

The Senior Debtholders have invested their funds and their time to dialogue, negotiations and discussions with the Debtor in order to bring about a resolution which they believe is reasonable, fair, and beneficial to all creditors of this Debtor. The Senior Debtholders have agreed to support the Debtor's Amended Plan because they believe the Amended Plan is fair and reasonable. With the modifications which the Debtor has agreed to make, the Amended Plan is acceptable to the Senior Debtholders. Participants in the capital markets, such as the Senior Debtholders, are skilled in evaluating proposed treatment by a Chapter 11 debtor. They have determined, given the information presented in the Second Amended Disclosure Statement filed by the Debtor, that the course charted by the Debtor is acceptable to the capital markets. (See Declarations of Tennessee, ¶¶12 and 13; Ohio STRS, ¶14; DCWASA, ¶¶12 and 14; and PIMCO, ¶ ¶ 12 and 14.) If the Senior Debtholders did not believe that this was the appropriate course for the Debtor to take, they would not have executed the Settlement Agreement. To the contrary, the Senior Debtholders believe that, in entering into the Settlement Agreement, the Debtor is taking appropriate action for the benefit of the Estate and its creditors. The Senior Debtholders are firmly committed to a quick, effective and appropriate exit by the Debtor from the bankruptcy process for the sake of the Estate, for the capital markets and also for the State of California. If the Debtor was to return to the capital market again in the absence of establishing its credibility, debt investors who have supplied funding in the past will be unwilling to advance funds in the future or only at a high price. (See Declarations of Tennessee, ¶13; Ohio STRS, ¶¶14 and 15; DCWASA, ¶¶14 and 15; and PIMCO, ¶ 15.) The ultimate goal of a bankruptcy proceeding is for the debtor and its creditors to reach a fair and reasonable resolution which provides the greatest benefit to all parties to the proceeding. It is the Senior Debtholders' belief that the Settlement Agreement accomplishes this goal.

D. The Plan Proponents' Requirement that the Senior Debtholders Vote for the Plan is Entirely Proper

As a part of the Settlement Agreement, the Senior Debtholders have agreed to vote for the Plan (1) if the Disclosure Statement is approved; (2) if the Settlement Agreement is approved by the Court; and (3) if a certain percentage of Class 5 Claimants consent to terms consistent with the Settlement Agreement. The Senior Debtholders' agreement to vote for the Plan if these conditions are fulfilled is wholly appropriate in order to resolve the issues between the parties and to encourage the Debtor's acceptance into the capital markets.

At present, it is the reasoned judgment of the Senior Debtholders that the Plan offers the Reorganized Debtor the best chance of success and provides creditors the best potential for meaningful recovery. The competing plan proposed by others does not sufficiently meet the Senior Debtholders' expectations and is plagued with various legal and financial problems. If a competing plan is proposed which would, in an objective sense, provide a greater return for creditors and offer the Reorganized Debtor an even more promising future, the Settlement Agreement does not require that the Senior Debtholders vote against the competing plan. Rather, under the Settlement Agreement, the Senior Debtholders may simply abstain from the vote on the competing plan. Therefore, if a "better" competing plan is proposed, its approval and confirmation would be up to the other creditors, the Debtor and the Court. Obviously, the Senior Debtholders reserve their rights to object to any plan that provides, in their estimation, a less meaningful recovery for them than does the Plan. The Senior Debtholders maintain the right to take whatever actions they believe are appropriate to protect their rights and interests. Simply put, if there should ever be a *"better competing plan,"* which presently the Senior Debtholders do not believe is reasonably foreseeable, the Senior Debtholders would not be a *"negative force,"* since they are not contractually obligated to vote against the competing plan.[7]

The Senior Debtholders are firmly committed to the Debtor's quick, effective and appropriate exit from the bankruptcy process, for not only the sake of the Estate, but for the capital markets and the State of California. It is the belief of the Senior Debtholders that the financial credibility of the State, the CPUC and the Debtor is at stake in this bankruptcy proceeding. The Settlement Agreement should be approved because it is a significant attempt to rehabilitate the financial credibility of the Debtor and the State and it is necessary to ameliorate the damage inflicted on the capital market participants, including the Senior Debtholders.

IV. CONCLUSION

For all the foregoing reasons, the Debtor respectfully requests that this Court make and enter an order that (a) approves the Settlement Agreement, (b) authorizes the payment of Pre-Petition Interest and Post-Petition Interest to the holders of undisputed Claims specified herein, (c) authorizes the Debtor to bring current and to pay, on an ongoing basis, the fees and expenses of indenture trustees and paying agents specified herein and (d) authorizes the Debtor, without further approval from this Court, to enter into future settlement agreements with other creditors on substantially similar terms as the Settlement Agreement.

---

7 Further, the Settlement Agreement specifically provides that any *"breach of the Settlement Agreement"* is to be specifically determined and judged by the Bankruptcy Court. Thus, only the Court can determine whether or not a party is improperly enforcing the Settlement Agreement contrary to the principles of the Bankruptcy Code and contrary to the fiduciary duties which the parties may owe.

CHAPMAN AND CUTLER

PASCOE & RAFTON

DATED: March 19 2002.

William R. Pascoe (#54284)

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
COVAD COMMUNICATIONS GROUP, INC.,	)	Case No. 01-10167
	)	
Debtor.	)	
	)	

Objection Deadline: TBD
Hearing Date: TBD

DEBTOR'S MOTION FOR ORDER PURSUANT TO SECTION 365(a) OF THE BANKRUPTCY CODE AUTHORIZING DEBTOR TO ASSUME ESCROW AGREEMENT CONCERNING NOTEHOLDER DISTRIBUTIONS

The above-captioned debtor and debtor in possession (the "Debtor" or "Covad") hereby moves the Court for entry of an order, pursuant to section 365(a) of chapter 11 of title 11 of the United States Code (as amended, the "Bankruptcy Code"), authorizing the Debtor to assume its escrow agreement with Wilmington Trust Company as "Noteholder Representative" and Citibank N.A. as Escrow Holder, in respect of which Covad deposited $256,742,701 prior to the commencement of this case (the "Escrow Agreement").[1] In support of this Motion, the Debtor respectfully states as follows:

Jurisdiction

1. This Court has jurisdiction over this Motion under 28 U.S.C. §§ 157 and 1334. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(B)(2)(A) and (O). Venue of these proceedings and the Motion is proper in this District pursuant to 28 U.S.C. §§ 1408 and 1409.

[1]Neither the Debtor nor the Noteholders (upon information and belief) concede that the Escrow Agreement is an executory contract, but out of an abundance of caution, seek the assumption thereof pursuant to Section 365 of the Bankruptcy Code.

2. The statutory bases for relief herein are sections 105(a) and 365(a) of the Bankruptcy Code.

3. As there are no novel issues of law presented herein, the Debtors waive their right to file a brief in support of the Motion, pursuant to Rule 7.1.2(a) of the Local Rules of Civil Practice and Procedure of the United States District Court for the District of Delaware, incorporated by reference into the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware by Rule 1001-1(b). Because of the nature of the relief requested in this Motion, the Debtors believe that no briefing is required.

Preliminary Statement

4. This case constitutes a pre-arranged bankruptcy case with the majority holders of the Debtor's more than $1.35 billion in outstanding Notes (as defined below). These Notes constitute the vast majority of the Obligations owing by Debtor. Although the Debtor has not formally solicited votes for the acceptance of its plan of reorganization (the "Plan") to be filed on or about August 22, 2001, it believes that it will have more than adequate support, subject to compliance with all proper solicitation procedures, to confirm the Plan in a timely and efficient manner. The Debtor expects its case to efficiently proceed towards confirmation of the Debtor's Plan in a relatively short period of time.

5. In July 2001, the Debtor began exploring strategic alternatives to address its operating losses and need to attract new investment. After extensive, arm's length negotiations to address these problems, the Debtor entered into the Agreements Concerning Voting (the "ACVs") with certain holders of Notes, holding in excess of 54% of the total principal amount of the Notes. A form of the ACVs is attached hereto as Exhibit "A".

6. The ACVs, among other things, (a) set forth the terms of a consensual restructuring of the Debtor's obligations that provides for a distribution to the holders of the Notes (the "Noteholders"), (b) contemplate the Debtor filing its chapter 11 bankruptcy and embodying the terms of that consensual restructuring in the Plan, (c) require the Noteholders to vote for, and support confirmation of, the Plan, subject to compliance with all proper solicitation procedures and (d) require Debtor to escrow the $256 million in cash consideration payable to the Noteholders under the Plan (the "Escrow" and the "Escrow Cash") pursuant to the Escrow Agreement. The Escrow Agreement is attached hereto as Exhibit "B". The ACVs and the Escrow Agreement also provide for the release of the Escrow Cash to the Noteholder Representative in the event the Plan is not timely confirmed or Covad otherwise defaults under the ACVs.

7. Debtor is required by the ACVs to move immediately to assume the Escrow Agreement in this case.

Background

8. This case was commenced by Debtor's filing of a voluntary petition on August 15, 2001.

9. The Debtor continues in possession of its properties and is operating and managing its business as debtor-in-possession pursuant to Bankruptcy Code §§ 1107(a) and 1108.

10. No request has been made for the appointment of a trustee or examiner, and no official committee of creditors or equity security holders has been established.

11. Covad is a corporation organized under the laws of the State of Delaware. Covad was incorporated in 1997. Covad's principal place of business is Santa Clara, California.

12. Covad is a holding company with no revenue generating business operations. All such operations are performed by direct and indirect operating subsidiaries (the "Subsidiaries"). Covad, however, is itself a party to certain contracts and real estate leases entered into on behalf of the Subsidiaries.

13. Through its Subsidiaries,[2] Covad is a leading provider of broadband communications services, which it sells to businesses and consumers directly and indirectly through Internet service providers, enterprises telecommunications carriers and other customers. These services include a range of high-speed, high-capacity internet and network access services using digital subscriber line ("DSL") technology and related value-added services. Covad's Subsidiaries sell these services directly to businesses and consumer end-users through its sales force, telephone sales and its website. Internet service providers purchase these services in order to provide high-speed Internet access to business and consumer end-users.

14. Covad's Subsidiaries operate out of offices primarily in California.

15. Branded virtual service providers also purchase turnkey broadband or dial-up services from Covad's Subsidiaries and sell these services to their existing customers or affiliate groups. Enterprise customers purchase services directly or indirectly from Covad's

[2] Covad's direct and indirect Subsidiaries are Covad Communications Company, a California corporation; DIECA Communications, Inc., a Virginia corporation; Covad Communications Investment Corp., a Delaware corporation; BlueStar Communications Group, Inc., a Delaware corporation; Lightsaber Acquisition Co., a Delaware corporation; Covad Canada Communications, Inc., a Canada corporation; Covad Europe Sarls; Covad Communications International B.V.; Loop Holdings Europe ApS; BlueStar Communications, Inc., a Tennessee corporation, d/b/a Covad Business Solutions; BlueStar Networks, Inc., a Tennessee corporation; Covad Communications GmbH; and Covad France.

Subsidiaries to provide their employees with high-speed remote access to the enterprise's local area network. Other telecommunications carriers purchase Covad's services for resale to their Internet service provider affiliates, Internet users and enterprise customers.

16. Covad indirectly owns the nation's largest DSL network that is not owned by a traditional telephone company, encompassing more than 1700 operational central offices and passing more than 40 million homes and businesses in 94 metropolitan statistical areas. As of March 31, 2001, Covad and its Subsidiaries had 319,000 DSL based high speed access lines in service and had received orders from more than 250 Internet service-provider, enterprise, and telecommunications carrier customers, including AT&T Corporation, XO Communications (formerly NEXTLINK Communications, Inc. and Concentric Network Corporation), EarthLink, Inc., UUNET Technologies (a WorldCom company) and Speakeasy.net, a privately owned company. Covad also provides dial-up Internet access service to over 400,000 subscribers through a Subsidiary, d/b/a Covad Integrated Services, Inc.

17. DSL technology first emerged in the 1990s and is commercially available today to address performance bottlenecks of the public switched telephone network. DSL equipment, when deployed at each end of standard copper telephone lines, increases the data carrying capacity of copper telephone lines from analog modem speeds to 56.6 kilobits per second (for the fastest consumer modems).

18. As of the Petition Date, Covad (as a holding company) has five employees. Additionally, there are several hundred employees employed by the remaining operating Subsidiaries of Covad.

A. The Crisis In The Telecommunication Industry

19. Covad was formed to capitalize on the business opportunity created by the growing demand for broadband Internet and network access, the commercial availability of low-cost DSL technology and the passage of the 1996 Telecommunications Act which encouraged competition in the industry. Several other potential competitors in the area were also organized during the same time period.

20. The rollout of a DSL network (or any other broadband network), is an extraordinarily capital-intensive endeavor. Moreover, profitability realistically cannot be attained until the network reaches a "critical mass" of customers which cannot realistically be projected until years into the future.

21. Covad was established and its business plan was presented at a time when the capital markets were extremely receptive to undertaking the business risk of establishing such a network.

22. Covad financed its growth through the issuance of high yield debt in the capital markets, held primarily by institutions. Covad currently has outstanding in excess of $1.35 billion in such high yield indebtedness, detailed as follows:

$208,700,000	13.5% senior discount notes due 2008 (the "1998 Notes")
$215,000,000	12.5% senior notes due 2009 (the "1999 Notes")
$425,000,000	12.0% senior notes due 2010 (the "2000 Notes")
$500,000,000	6.0% convertible notes due 2005 (the "2000 Convertible Notes")[3]

[3] The 1998 Notes, the 1999 Notes, the 2000 Notes and the 2000 Convertible Notes are hereinafter collectively referred to as the "Notes".

23. The telecommunications and high-speed internet access industries are now in a period of tremendous turmoil. The "buildout" of the broadband internet network contemplated during Covad's (and its competitor's) business plans requires the infusion of substantial additional capital. The capital markets, however, have become extremely restrictive over the past 18 months. Covad's largest competitor, Northpoint Communications, commenced its own chapter 11 case in 2000. That chapter 11 case resulted in a liquidation of the company.

24. Additionally, a number of the Internet service provider customers of Covad (including Flashcom, Inc., Fastpoint Communications, Inc., Zyan Communications, and Relay Point, Inc.) have filed for chapter 11 protection.

25. Covad requires additional capital in order to offset operating losses until Covad attains profitability. Given the tightening of the capital markets, however, this effort is made more difficult, particularly given the magnitude of the outstanding Notes already issued by Covad.

26. Covad believes that the holders of Covad's Notes and Covad's other creditors essentially agree with the foregoing analysis. Therefore, before the commencement of this chapter 11 case, Covad engaged in extensive negotiations with the primary holders of its Notes in an effort to negotiate a consensual restructure of the obligations owing by Covad. This case was filed for the purpose of implementing that restructure.

B. Covad's Obligations

27. As mentioned, Covad has over $1.35 billion in Note indebtedness. Covad also is liable in the amount of ongoing obligations relating to real estate leases and certain

contracts. Covad estimates that its trade debt will not ultimately exceed $10,000,000 (including damages resulting from the rejection of certain unexpired leases and executory contracts).

28. Contingent claims against the Company also include claims asserted in various securities fraud lawsuits against Covad that Covad is defending (collectively, the "Litigation Claims").

C. The Filing

29. Covad requires additional capital in order to offset operating losses until Covad's Subsidiaries attain profitability. Given the tightening of the capital markets, however, this effort has been made extremely difficult, particularly given the magnitude of the outstanding Notes already issued by Covad.

30. At least the majority of the holders of the Noteholders agree with the foregoing analysis. Therefore, as mentioned before the commencement of this chapter 11 case, Covad engaged in extensive negotiations with the primary holders of its Notes in an effort to negotiate a consensual restructure of the obligations owing by Covad. These negotiations culminated in the execution of the ACVs and the Escrow Agreement. This case was filed for the purpose of implementing that restructure.

D. The Escrow Agreement

31. Under the ACVs, Noteholders agreed to an enormous discounting of the obligations owed by Covad in respect of the Notes. Covad's obligations under the Notes total over $1.35 billion. Pursuant to the ACVs, the Noteholders agreed to support a plan of reorganization (the "Plan") which satisfied those claims by Covad's cash payment of $256,782,701 (approximately 19.1 cents on the dollar), and a 15% equity interest in Covad upon

confirmation. Covad hopes and expects that this elimination of over $1 billion in indebtedness from its balance sheet will permit Covad to attract the investment necessary to permit Covad to reach profitability.

32. The Noteholders required in consideration for the execution of the ACVs that Covad escrow the $256,782,701 in cash (the "Escrowed Cash") that would be payable on account of the Notes under the Plan. As indicated above, Covad agreed and deposited $256,782,701 in the Escrow established by the Escrow Agreement on August 15, 2001, just prior to the filing of this Case.

33. A true and correct copy of the Escrow Agreement is attached hereto as Exhibit "A". The Escrow Agreement provides that the Noteholders will be entitled to the release of the Escrowed Cash if Covad misses any of various deadlines in the Plan Confirmation process, or if the Plan is confirmed, that entitles the Noteholders to the Escrowed Cash. The principal such deadlines are that Covad must file its Plan by September 15, 2001, commence solicitation of acceptances by November 15, 2001, and the effective date of the Plan must occur by January 15, 2002.

34. Covad intends to file its Plan and accompanying Disclosure Statement within the next few days. Covad believes that all of the benchmarks imposed on Covad by the Escrow Agreement are attainable.

35. Covad is entitled to return of the Escrowed Cash under the Escrow Agreement if Noteholders do not accept Covad's Plan as a class. As indicated, the holders of 54% of the Notes (in amount) have already executed ACVs. The assumption of the Escrow

Agreement hopefully will have the effect of inducing sufficient remaining Noteholders to accept the treatment of Claims under the Notes as laid out under the ACVs.

Basis For Relief

36. Section 365(a) of the Bankruptcy Code provides that a debtor in possession, "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). The decision to assume or reject an executory contract or unexpired lease is a matter within the "business judgment" of the debtor. See In re Taylor, 913 F.2d 102 (3d Cir. 1990); Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp., 872 F.2d 36 (3d Cir. 1989). The Debtor, in an exercise of its business judgment, believes that the Escrow Agreement should be assumed now because its assumption is in the best interest of the Debtor's efforts to reorganize.

37. The Escrow Agreement represents the agreement between the Debtor and approximately 54% of its Noteholders to the proposed restructuring of the Debtor and is an integral component in consummating the proposed consensual restructuring of the Debtor. If the Court grants this Motion, the remaining 46% of the Noteholders (the "Remaining Noteholders") will realize that the Debtor's proposed restructuring is certain and not tenuous. Additionally, the granting of the Motion will ensure the Remaining Noteholders that the approximately $256,000,000 which the Debtor proposes to pay to the Noteholders is being held in escrow and is available for distribution if the requisite support of two-thirds of the Noteholders is obtained. Accordingly, the Remaining Noteholders will be more likely to support the Debtor's restructuring and will not fear that the Debtor's case will turn into a liquidation as have the cases of many companies involved in this industry.

38. If the Debtor obtains the approval of two-thirds of the Noteholders, such support will not only help in achieving a quick restructuring but will also assist the Debtor in conducting its business operations. Customers of the Debtor have already witnessed the liquidation of competitors such as Northpoint Communications and the commencement of Chapter 11 cases by other industry players. In order for the Debtor to assuage the fears of such customers and to sustain its operational base during this financial restructuring, it is essential that the Debtor demonstrate to such customers that the Debtor has generated sufficient support to implement a plan of reorganization. Similarly, the Debtor submits that the assumption of the Escrow Agreement, will assist it in its efforts to access the capital markets and thereby contribute to the Debtor's restructuring and continued viability.

39. Additionally, one of the primary purposes of Chapter 11 is to encourage out of court restructuring between creditors and debtors. The assumption of the Escrow Agreement helps foster this policy by ensuring that prepetition restructuring arrangements are honored. If the Escrow Agreement is not assumed, debtors and creditors would be discouraged from entering into prepetition restructuring negotiations.

40. Based on the foregoing, the Debtor believes that the assumption of the Escrow Agreement is in the best interest of the Debtor's creditor and the estate.

Notice

41. Notice of this Motion has been given to (i) the United States Trustee; (ii) counsel for the Unofficial, Prepetition Noteholder Steering Committee, (iii) the creditors holding the twenty largest unsecured claims, (iv) the Noteholder Representative, (v) the Escrow Agent, and (vi) those parties requesting special notice pursuant to Federal Rule of Bankruptcy

Procedure 2002. In light of the nature of the relief requested, the Debtors submit that no further notice is required.

No Prior Relief

42. No previous application for the relief sought herein has been made to this or any other Court.

WHEREFORE, the Debtor respectfully requests that the Court enter an order, substantially in the form attached hereto authorizing the Debtor to assume the Escrow Agreement, and granting such other and further relief as is just and proper.

Dated: August 16, 2001

PACHULSKI, STANG, ZIEHL, YOUNG & JONES P.C.

Laura Davis Jones

Laura Davis Jones (Bar No. 2436)
Christopher J. Lhulier (Bar No. 3850)
David W. Carickhoff (Bar No. 3715)
919 North Market Street, 16th Floor
P.O. Box 8705
Wilmington, Delaware 19899-8705 (Courier 19801)
Telephone: (302) 652-4100
Facsimile: (302) 652-4400

PACHULSKI, STANG, ZIEHL, YOUNG & JONES P.C.
Richard M. Pachulski (CA Bar No. 90073)
Brad R. Godshall (CA Bar No. 105438)
Scotta McFarland (CA Bar No. 165391)
10100 Santa Monica Boulevard, Suite 1100
Los Angeles, California 90067
Telephone: (310) 277-6910
Facsimile: (310) 201-0760

[Proposed] Counsel to Debtor and Debtor in Possession

Filed in open Ct 11/21 9:00am
nhm

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
COVAD COMMUNICATIONS GROUP, INC.,	)	Case No. 0110167
	)	
Debtor.	)	
	)	

ORDER, UNDER 11 U.S.C. § 365(a), AUTHORIZING DEBTOR TO ASSUME ESCROW AGREEMENT CONCERNING NOTEHOLDER DISTRIBUTIONS

Upon the motion (the "Motion") of the debtor and debtor in possession in the above-captioned chapter 11 case (the "Debtor") seeking entry of an order under section 365(a) of title 11 of the United States Code, authorizing the Debtor to assume the escrow agreement (the "Escrow Agreement"), without further order of this Court; and no previous application having been made; and upon consideration of the Motion; and due and proper notice of the Motion having been given; and it appearing that assumption of such Escrow Agreement and the procedure approved herein is in the best interests of the Debtor, its estate and creditors, it is hereby

ORDERED that the Motion is granted; and it is further

ORDERED that the Escrow Agreement is deemed assumed; and it is further

ORDERED that this Court shall retain jurisdiction to hear and determine all matters arising from the implementation of this Order.

November 21
Dated: ~~August~~ ___, 2001

Joseph J. Farnan Jr.
Judge

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re	:	Chapter 11
COVAD COMMUNICATIONS GROUP, INC.,	:	
Debtor.	:	Case Number 01-10167 (JJF)
	:	

Hearing Date: September 12, 2001 @ 11:00 A.M.
Objection Deadline: September 7, 2001 @ 4:00 P.M.
(extended by agreement)

OBJECTION OF THE UNITED STATES TRUSTEE TO DEBTOR'S MOTION FOR ORDER PURSUANT TO SECTION 365(a) OF THE BANKRUPTCY CODE AUTHORIZING DEBTOR TO ASSUME ESCROW AGREEMENT CONCERNING NOTEHOLDER DISTRIBUTIONS
(DOCKET ENTRY # 20)

In support of her Objection to Debtor's Motion for Order Pursuant to Section 365(a) of the Bankruptcy Code Authorizing Debtor to Assume Escrow Agreement Concerning Noteholder Distributions, Patricia A. Staiano, the United States Trustee ("UST") for Region 3, by and through her counsel, avers (Note: Capitalized terms other than the words "Court," "Motion," "Objection" and "UST" shall have the same meaning given to them in the Motion):

1. This Court has jurisdiction to hear this Objection.

2. Pursuant to 28 U.S.C. § 586, the UST is charged with oversight of the federal bankruptcy system. *See Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.),* 898 F.2d 498, 500 (6th Cir. 1990) (describing the UST as a "watchdog").

3. Pursuant to 11 U.S.C. § 307, the UST has standing to be heard with regard to this Objection.

4. Chapter 11 of the Bankruptcy Code contains several provisions which protect the rights of creditors in the reorganization. *See Institutional Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.)*, 780 F.2d 1223, 1227 (5th Cir. 1986). The disclosure requirements associated with the plan process and the absolute priority rule are two examples of such protections. *See Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983).

5. The instant Motion is nothing less than a "Plan B." The purpose of the instant Motion is to transfer more than a quarter-billion dollars to the Noteholders if a Noteholder Entitlement Event occurs (Escrow Agreement ¶ 1(a)). Paraphrased, the Escrow Agreement provides that, if the Noteholders hold up their end of the "lock-up" bargain but the Plan filed by the Debtor is not effective as of January 15, 2002, the Noteholders get the money.

6. The Motion is effectively a *sub rosa* plan; the Debtor seeks approval of the Escrow Agreement, an agreement which expressly contemplates the possibility of transferring a quarter-billion dollars to the Noteholders prior to confirmation. Apparently, as part of the escrow and "lock-up" agreements, the Noteholder Agent holds a security interest in the escrow which is extinguished upon the Effective Date of the Plan or (presumably) a Company Return Event (Disclosure Statement, Section VII(B), "Noteholder Negotiations," pgs. 39-42).

7. If the Debtor's Plan is not confirmed in a timely fashion as contemplated by the Escrow Agreement and the Noteholders get the escrowed monies, the principle underlying the absolute priority rule will be violated. *See* 11 U.S.C. § 1129(b)(2)(B); *see also In re Work Recovery, Inc.*, 202 B.R. 301, 304 (Bankr. D. Az. 1996) (court should consider whether granting relief will render creditors' rights under other provisions of Chapter 11 meaningless when evaluating *sub rosa*

plan issue). Trade debt holders and securities claim holders would receive no distribution while equity stays put.

8. The UST leaves the Debtor to its burden.

WHEREFORE the UST requests that this Court issue an order denying the Debtor's Motion and/or granting such other relief that this Court deems appropriate.

Respectfully submitted,

PATRICIA A. STAIANO
UNITED STATES TRUSTEE

BY: /s/ Joseph J. McMahon, Jr.
Joseph J. McMahon, Jr., Esquire
Trial Attorney
J. Caleb Boggs Federal Building
844 King Street, Room 2313, Lockbox 35
Wilmington, DE 19801
(302) 573-6491
(302) 573-6497 (Fax)

Date: September 7, 2001

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

In re:	)	Chapter 11
COVAD COMMUNICATIONS GROUP, INC.,	)	Case No. 01-10167 (JJF)
	)	
Debtor.	)	

OMNIBUS OBJECTION OF NON-CONSENTING NOTEHOLDERS TO DEBTOR'S MOTIONS FOR (I) ORDER PURSUANT TO SECTION 365(a) OF THE BANKRUPTCY CODE AUTHORIZING DEBTOR TO ASSUME ESCROW AGREEMENT CONCERNING NOTEHOLDER DISTRIBUTIONS AND (II) ENTRY OF THE AGREED ORDER BETWEEN THE PLAINTIFFS AND THE DEBTOR GRANTING LIMITED RELIEF FROM THE AUTOMATIC STAY

Leonardo, L.P., Ramius Capital Group LLC and Quattro Global Capital, LLC,[1] current and former holders of over $52.75 million in principal amount of the Debtor's 6% Convertible Notes due 2005 (collectively, the "Non-Consenting Noteholders"), by their undersigned attorneys, hereby submit their objection (the "Objection") to the Debtor's Motions For (I) Order Pursuant To Section 365(a) Of The Bankruptcy Code Authorizing Debtor To Assume Escrow Agreement Concerning Noteholder Distributions (the "Escrow Motion") and (II) Entry Of The Agreed Order Between The Plaintiffs And The Debtor Granting Limited Relief From The Automatic Stay (the "Class Action Motion" and together with the Escrow Motion, the "Motions"). In support of this Objection, the Non-Consenting Noteholders respectfully represent as follows:[2]

---

[1] Quattro Global Capital, LLC no longer holds any of the Debtor's notes, but, as described below, still possesses significant claims against the Debtor in connection with the pre-petition litigation commenced by the Non-Consenting Noteholders.

[2] Capitalized terms not otherwise defined have the same meaning as in the Motions.

Preliminary Statement

The Motions are the first step in the Debtor's effort to short-circuit the chapter 11 process, sweep significant claims of mismanagement and securities fraud under the rug, cram down a restructuring on objecting creditors without answering basic questions about feasibility and fairness, and force a distribution scheme upon all noteholders that plainly violates the priority scheme mandated by the Bankruptcy Code. The Debtor proposes to coerce the Non-Consenting Noteholders and other creditors into taking nineteen cents on the dollar in cash and 15% of the reorganized company's equity in exchange for the cancellation of over $1.3 billion in debts, while at the same time leaving existing shareholders relatively unimpaired with the remaining 85% of the Debtor's equity. In addition, the Debtor requests that the Court ratify a quick settlement (using insurance proceeds and common stock to which all creditors of the Debtor's estate are properly entitled and again preferring shareholders over creditors) with various class action plaintiffs in order to insulate its officers and directors from serious charges of mismanagement and securities fraud.

The Motions, filed on the first day of this bankruptcy case, ask the Court to lock into place an integral component of a pre-negotiated plan of reorganization (the "Plan"), and to do so based on wholly inadequate and, in some cases, non-existent factual showings. In essence, the Debtor seeks to erase over $1 billion in defaulted debt for pennies on the dollar so it can go out to the markets and raise more debt it may not be able to repay. As an extra bonus for management, the Debtor wants to absolve management from any claims of fraud or mismanagement arising from the remarkable fact that the Debtor went into default less than a year after it raised half a billion dollars of new debt with which to continue its operations.

This Plan cannot be hustled through the bankruptcy process on a fast track. It does not reflect a consensus among a broad range of all stakeholders; it does not result from a full airing of the pros and cons of the settlement; it does not assure the economic viability of the reorganized company; and it does not even attempt to establish the fairness of the quick insurance settlement of claims against officers and directors. This Plan is supported by only a slim majority of noteholders (the "Consenting Noteholders"), who undertook to set aside hundreds of millions of dollars of the Debtor's cash under an escrow agreement governed by terms negotiated and controlled only by themselves and implementing only that group's idea of a desirable plan of reorganization. Significantly, the Motions make no disclosure as to the interests or connections of those Consenting Noteholders, or the basis for their determination that the proposed settlement and Plan are desirable. In view of the serious allegations of misconduct against Covad and its management, as well as the Motions' singular lack of adequate disclosure, the Non-Consenting Noteholders will shortly file a motion for appointment of an examiner pursuant to 11 U.S.C. § 1104 (c).

At a minimum, prudence dictates that the proposed class action settlement – a settlement that would release valuable claims against Covad, its officers and directors, and others – must await adequate investigation of its reasonableness by an examiner and by the independent creditors and shareholders who would be adversely affected by the settlement.

Moreover, assumption of the Escrow Agreement, which is part and parcel of voting lockup agreements executed prepetition with certain noteholders (the Agreements Concerning Voting or "ACV's"), also violates the rights of Non-Consenting Noteholders by unnecessarily locking all noteholders (and other unsecured creditors) into a distribution scheme and causing a release of claims before the Debtor's disclosure has been tested through the plan confirmation process. The Debtor does not have the requisite number or amount of noteholder claims to gain approval of its Plan. Accordingly, this Court should not condone a first-day lockup of the terms of the Plan until the full due process afforded creditors under chapter 11 has been implemented. Indeed, the proposed Plan is unconfirmable on its face. It clearly violates the absolute priority principles and fails to make adequate disclosure as to liquidation or alternative plan values, and the like.

Conversely, there is little prejudice to the Debtor, to those noteholders consenting to the nineteen-cent recovery, or to the class action plaintiffs in putting off the decision whether to assume the Escrow Agreement and whether to authorize the class action settlement. These issues will be – and must be – fully addressed as an integral part of the plan process. The Escrow Agreement will continue to be a binding obligation of the Debtor until formally rejected, and, in any event, the class action plaintiffs must await the conclusion of the Debtor's case before they can collect on any settlement. In addition, any purported fear the Debtor has that failure to assume the Escrow Agreement and approve the class action settlement now will prevent confirmation of the Plan (assuming it is confirmable) is baseless. Those noteholders signing the ACV's, as well as the class action plaintiffs, can always vote to approve a plan that provides for their respective recoveries as set forth in the ACV's and the class action settlement. The Court simply does not need to enter the drastic relief requested by the Motions at this time.

For all these reasons, and as demonstrated in more detail below, the Court should deny the Motions in their entirety.

Factual Background

Covad's Recent Performance

1. Covad, a provider of broadband communication services, holds itself out as a pioneer in providing an improved method of connecting to the Internet known as digital subscriber lines or "DSLs", and as the nation's largest DSL network not owned by a traditional telephone company. Prior to the bankruptcy filing, Covad was a holding company operating through a number of subsidiaries. Its five employees were all officers and directors of its operating subsidiary, Covad Communications Company ("Communications").

2. Covad claims that it and its subsidiaries generated staggering losses in 2000 of <u>$1.354 billion</u> based on revenues of only $158.7 million.[3] Covad financed this fiasco through the public debt and equity markets, selling approximately $208 million in notes in 1998, $215 million in 1999, and <u>$925 million in 2000</u>. As of the Debtor's bankruptcy filing, approximately <u>$1.35 billion</u> of this debt remains outstanding and in default. Covad is also liable on real estate leases, trade and other unsecured debt, and for contingent damages asserted in securities fraud lawsuits. Escrow Motion paragraphs 22 and 27. In the understatement of the year, Covad says:

> [Covad] requires more capital in order to offset operating losses until Covad attains profitability. Given the tightening of the capital markets, however, this effort is made more difficult, particularly given the magnitude of the outstanding Notes already issued by Covad.

Escrow Motion, paragraph 25. Covad also alleges that it has signed voting lockup agreements with approximately 54% (in amount) of its Noteholders who have agreed to "an enormous discounting of the obligations owed by Covad in respect of the Notes" in exchange for 19.1 cents in cash and 15% of the equity of the reorganized company. Covad further states that it "hopes

[3] In contrast, in 1999, the Debtor lost $177 million on revenues of $66.5 million.

and expects that this <u>elimination of over $1 billion in indebtedness</u> from its balance sheet will permit Covad to reach profitability." Escrow Motion, paragraph 31 (emphasis added).

3. Notwithstanding Covad's purported hopes for future profits, Covad itself recognizes that there is a "Crisis in the Telecommunications Industry" (heading A to the Escrow Motion). Covad admits that the capital markets no longer tolerate the excessive capital costs of building these telecommunications networks and the years of operating losses required to achieve the critical mass of customers necessary to become profitable. Indeed, Covad acknowledges that some of its competitors are also filing for bankruptcy and in some cases liquidating. Escrow Motion, paragraphs 20, 21, 23 and 24. In view of the turmoil in the telecommunications market and the catastrophic past performance of Covad's management, one can only have grave doubts about Covad's chances for rehabilitation. Those doubts are only deepened by Covad's apparent intent, under its Plan, to assume the obligation to indemnify and hold harmless its officers and directors for all claims against them.

4. Covad marketed the last $500 million of its debt offerings in the fall of 2000. The Non-Consenting Noteholders purchased over $52.75 million in principal amount of Covad's 6% Convertible Notes (the "6% Notes") issued on or about September 25, 2000. In its marketing materials and road shows for this half-billion dollars in debt, Covad represented to the Non-Consenting Noteholders, and undoubtedly to others, that it was relatively immune to the downturn in the technology sector due in part to the high creditworthiness of its customer base and the stable collectibility of millions of dollars of receivables from, among others, Internet service providers. In fact, on information and belief, at the very time Covad's management was

marketing a half-billion dollars of debt instruments, it knew that its financial representations concerning collectibility of key receivables were materially overstated, but it denied this to potential purchasers of its debt. Remarkably, on October 17, 2000, barely three weeks after it closed the sale on its last $500 million in notes, Covad publicly acknowledged the material overstatements of its receivables collection numbers. By May, 2001, when it belatedly filed its year-end audited financials, Covad admitted overstating revenue by more than $36 million for the first two quarters of 2000. Covad's shares were delisted from NASDAQ, and its outside auditors gave a "going concern" opinion on Covad's financial statements (i.e., questioning Covad's ability to survive as a going concern).

5. The Non-Consenting Noteholders believe, as set forth more fully below, in their accompanying Motion for Appointment of an Examiner and in their filings in related California securities fraud litigation (described below), that the Debtor's management was driven by a pathological need to show a favorable revenue stream even in the face of serious evidence to the contrary, and with full knowledge of Covad's highly ineffective management systems. This prior conduct does not bode well for a reorganized Debtor's ability to support the burdens of a new round of debt financing, especially in the midst of the current crisis in the telecommunications industry. The Non-Consenting Noteholders respectfully submit that this Court should not condone a potential repeat of Covad's pre-bankruptcy financial fiasco without full and diligent inquiry into the competence of management and the viability of a previously unviable business model.

The Proposed Class Action Settlements

6. On or about October 23, 2000, the Non-Consenting Noteholders commenced lawsuits against Covad Communications Group, Inc., Robert E. Knowling, Jr. Covad's Chairman and Chief Executive Officer, Mark H. Perry, Covad's Executive Vice President and Chief Financial Officer, in the Superior Court of the State of California for the County of Santa Clara. Their complaints seek damages for fraud and deceit by active concealment, omission, misrepresentation, negligent misrepresentation and negligence and state securities laws violations in connection with the issuance of the 6% Notes (the "Complaints"). Copies of the Complaints and the Motion for Summary Adjudication filed by the Non-Consenting Noteholders in June, 2001 are annexed as Exhibits A and B, respectively.[4]

7. The Non-Consenting Noteholders' actions against the Debtor, which have been stayed by Covad's bankruptcy filing, detail the reckless disregard for truthful disclosure that characterized Covad management's efforts to raise money to feed Covad's out-of-control operating losses.

8. As the Class Action Motion points out, numerous other lawsuits have been filed against the Debtor and its officers and directors relating to purchases and sales of the Debtor's debt securities and common stock, including cases in the United States District Court for the Northern District of California that have been consolidated in a single matter before that court (the "Federal Actions"). The Class Action Motion fails to disclose whether class status has been certified in the Federal Actions. The Class Action Motion does refer to "significant negotiations" between the plaintiffs and the defendants in the Federal Actions resulting in a

[4] The attached Motion for Summary Adjudication was filed under seal in California state court. In accordance with that procedure, these documents are redacted. Upon request, the Non-Consenting Noteholders will file the documents in full under seal with this Court.

Memorandum of Understanding for settlement of those actions and mutual releases of the parties. Under the proposed settlement, the defendants will pay plaintiffs $16.5 million from their directors and officers liability insurance (the "D&O policies"), in addition to which Covad will issue to the plaintiffs 3.5% of the fully diluted common shares of the Debtor. The Class Action Motion asks this Court's permission to seek approval of this settlement in the California court prior to any review of the settlement by this Court in the context of the plan confirmation process.

9. The Class Action Motion does not make any disclosure as to the basis for the proposed settlement. It does not even reveal the details of the claims asserted, the nature of the defendants' defenses to those claims, whether the settlement is fair and appropriate, how the proceeds of the settlement are to be allocated between creditor and shareholder claims, and numerous other factors that the Court and any party-in-interest would require in order to evaluate the propriety of the relief requested. The settlement is conditioned on, among other things, "the release by Covad of certain D&O policies, respecting the claims made in the Action." Class Action Motion Exhibit A at 3. This provision raises the question whether these policies are estate assets that should be distributed only in the context of a confirmed chapter 11 plan. The proposed settlement is further conditioned on the "resolution" of the Non-Consenting Noteholders' claims (id. at 3), although the Class Action Motion does not indicate how those claims could be "resolved" over the Non-Consenting Noteholders' objection.. In short, without even attempting to present any factual basis for the extraordinary relief requested, the Class Action Motion asks for leave to go to another court for approval of a settlement that would strip creditors of valuable claims, thereby benefit unspecified shareholders, creditors and plaintiffs'

lawyers, and release claims against non-debtor officers and directors, all outside of the statutory scheme for distributions under chapter 11. The abuse of process this Court is asked to condone is blatant and impermissible.

Argument

The Motions Should Be Denied As An Impermissible Attempt To Short-Circuit the Chapter 11 Process; At A Minimum, Consideration Of The Relief Requested Should Be Deferred Until A Hearing On Confirmation Of A Plan Of Reorganization

10. Prior to filing for bankruptcy protection, the Debtor reached agreement with a slim majority of its noteholders to cancel $1.3 billion in aggregate noteholder debt for approximately nineteen cents on the dollar, while leaving the Debtor's existing equity-holders with 85% of their interest in the reorganized Debtor. The specific terms of the arrangement between the Debtor and certain of its noteholders are contained in the ACVs. Pursuant to the ACVs, the Debtor, among other things, was required to enter into the Escrow Agreement and move immediately after filing for bankruptcy to assume the same. The Debtor has satisfied its burden under ACVs to move to assume the Escrow Agreement. Now, rather than authorize the Debtor to assume the Escrow Agreement and permit the Debtor to take the first step in its end run around the confirmation process, the Court should deny the Escrow Motion or hold it in abeyance until a hearing is held in connection with the confirmation of the Debtor's Plan. This would preserve the $256 million escrow fund created by the Escrow Agreement while permitting the creditor body, an examiner and the Court a reasonable opportunity to evaluate the fairness and feasibility of the proposed Plan. The Court should likewise deny the Class Action Motion to permit a full review of the proposed settlement as part of the plan process.

A. The Escrow Agreement Improperly Locks Noteholders Into A Limited Recovery That Violates The Absolute Priority Rule

11. The terms of the Escrow Agreement essentially put into effect the deal struck in the ACVs and the Debtor's proposed Plan. Noteholders would receive $256 million in cash and preferred stock convertible to fifteen percent of the Reorganized Debtor's common stock, while existing equity-holders would retain approximately 85% of their equity interests. If the noteholder class rejects the Plan, the escrowed funds will be returned to the Debtor. The Escrow Agreement also attempts to impose an extremely expedited schedule for confirmation of the Debtor's Plan. According to the Escrow Motion, Covad must file its Plan by September 15, 2001, commence solicitation of acceptances by November 15, 2001, and have the Plan become effective by January 15, 2002. Escrow Motion at paragraph 33. Pursuant to the Escrow Agreement, the Debtor filed its proposed Plan and Disclosure Statement in support of the Plan on August 27, 2001.

12. The Escrow Agreement is thus deliberately structured to coerce all noteholders, all other unsecured creditors, and the Court into a hurried acceptance of a Plan that pays creditors pennies on the dollar and discharges over a billion dollars of debt for no consideration, while leaving existing equity substantially unimpaired. If Covad is allowed to assume the Escrow Agreement, creditors will be forced either to accept the terms of the Plan or to release $256 million in cash back to the same management that has already squandered over $1.5 billon of the Debtor's assets.

13. This Hobson's choice is worse than unfair; it is against the law.

14. The courts refuse to approve disposition of a debtor's assets if the approval will have the effect of short-circuiting a formal plan of reorganization. See Collier on

Bankruptcy ¶ 1129.01[2] (15th ed. 2001). In particular, the court should reject any proposed transaction where the terms of the transaction would have "the practical effect of dictating some of the terms of any future reorganization plan." In re Braniff Airways Inc., 700 F.2d 935, 940, reh'g denied 705 F.2d 450 (5th Cir. 1983). As the court in Braniff concluded:

> The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan sub rosa in connection with [a proposed transaction]. In any future attempts to specify the terms whereby a reorganization plan is to be adopted, the parties and the district court must scale the hurdles erected in Chapter 11.

Id. at 940. See also The Committee of Equity Holders v. The Lionel Corp. (In re Lionel Corp.), 722 F.2d 1062 (2d Cir. 1983) (eschewing transactions or agreements which fix the terms of a plan by securing the court's imprimatur on pre-confirmation motions without the protections afforded creditors through the confirmation process); and see generally In re Marvel Entertainment Group, Inc., 222 B.R. 243 (D. Del. 1998); Sloane, The Sub Rosa Plan Of Reorganization: Side-Stepping Creditor Protections In Chapter 11, 16 Bankr. Dev. J. 37 (1999).

15. The relief requested is all the more objectionable because the Debtor's Plan is patently unconfirmable. First, because the Plan provides a recovery to equity, it simply cannot be confirmed absent the approval of all creditor classes, something that, at ~~this time,~~ is highly speculative.[5] See 11 U.S.C. § 1129(8). Indeed, at present only 54% in amount of the noteholder class has consented to the Debtor's proposed distribution and, pursuant to § 1126 of the

[5] As the Debtor is well aware, a plan that impairs creditor recoveries can only be confirmed if, in addition to meeting numerous other requirements, it is accepted by the impaired class of creditors or is crammed down on such class. As the Debtor also knows, a plan can only be confirmed pursuant to the cram down procedure if, among other requirements, no class of creditors or interests that is junior to the non-consenting class receives a recovery. Here, because the Debtor proposes to provide existing equity-holders, who are junior in right of recovery to the noteholders (and all creditors), with a recovery, the Debtor cannot utilize the cram down mechanism. Accordingly, in order to ultimately confirm the Plan, the Debtor must obtain approval by the all classes of creditors, including the noteholder class.

Bankruptcy Code, at least one-half in number and two-thirds in dollar amount must consent in order for a class to accept a plan. Accordingly, an additional 13% in amount (and an unknown number) of noteholders must agree to the treatment proposed by the Debtor in order for the Debtor to obtain approval by the noteholder class. As discussed below, absent approval by all creditor classes, including the noteholder class, the Plan cannot be imposed on creditors through the cram down process because the Plan provides a recovery to existing equity holders in violation of the absolute priority principles of the Bankruptcy Code. See 11 U.S.C. § 1129(b).

16. Second, it is highly questionable whether the Debtor's Plan can satisfy the numerous other conditions to confirmation, including the "best interest of creditors" and feasibility tests and the basic requirement that the Plan be proposed in good faith. To be confirmed, a plan must provide a greater recovery to creditors than they otherwise would receive in a hypothetical liquidation of the debtor entity. See 11 U.S.C. § 1129(a)(7). If the plan distribution achieves that result, it is said to be in the "best interest of creditors." Here, the Debtor may not be able to satisfy the "best interests" test. In its proposed Disclosure Statement, the Debtor asserts that there would be little or no assets to distribute to unsecured creditors in a hypothetical liquidation of the Debtor because, among other reasons, the Debtor is a holding company with little or no assets. The Debtor's argument completely ignores the fact that a chapter 7 trustee likely would seek to substantively consolidate the assets of the Debtor with all of its non-bankrupt subsidiaries and affiliates and thereby increase the assets of the estate that would be available for distribution to creditors. The Debtor also ignores the infusion of cash to the estate from its directors and officers' liability insurer. In a chapter 7 proceeding, it is likely that the Non-Consenting Noteholders and the class litigants would attempt to reduce their claims

to judgment and make larger demands on the Debtor's insurance than the currently proposed settlement.

17. To be confirmed, the Debtor must also demonstrate that its Plan is feasible (i.e., that the Debtor will be able to sustain operations without the need for subsequent bankruptcy protection) and proposed in good faith. See 11 U.S.C. § 1129(a)(3) and (11). Here, as noted above, serious questions abound concerning the Debtor's continued viability even as a drastically de-levered company. As a result of this concern, and as a result of the disproportionate recovery scheme that it proposes coupled with the release of claims against officers and directors, the Debtor simply cannot be said to have proposed its Plan in good faith.

18. Accordingly, it follows that the Debtor should not be permitted to assume the Escrow Agreement or, at a minimum, the Escrow Agreement Motion should not be decided until such time as the Court, an examiner and all creditors have a full and fair opportunity to put the Debtor's Plan to the tests required by the Bankruptcy Code. In either case, the escrowed $256 million should remain in escrow pending the outcome of the plan process.

A. Approval of the Class Action Settlement Is Premature And Improperly Seeks To Release Claims Against Non-Debtors

19. The Class Action Motion asks the Court to lift the automatic stay to permit the Debtor to obtain approval of the settlement of the Federal Actions. As noted, the settlement agreement provides for the payment of $16.5 million in insurance proceeds and the transfer of 3.5% of the Debtor's common stock to the class plaintiffs who hold certain of the Debtor's common stock and convertible notes. The settlement agreement also provides for a general

release of claims against the Debtor and its officers and directors.[6] Like the Escrow Agreement, the Debtor's bid for a quick settlement of the Federal Actions and a release of its officers and directors is another example of the Debtor's effort to dispose of estate assets without a proper review of the merits.

20. As set forth above, the Non-Consenting Noteholders have commenced actions asserting that the Debtor, its principal officers and other parties are liable for fraud, deceit and negligent misrepresentation in connection with the offering of the 6% Notes. Many of the allegations in the Federal Actions similarly relate to false and misleading representations made by the Debtor and its officers and directors in connection with the sale of Covad's debt and equity securities. Such allegations are far too serious simply to be dismissed by the general releases to be executed in connection with the class action settlement. Indeed, this is precisely why the Non-Consenting Noteholders are moving for the appointment of an examiner in this case. Accordingly, the automatic stay should not be lifted, and the proposed class action settlement should not even be considered until such time as an examiner and creditors' committee have an adequate opportunity to scrutinize and evaluate the fairness of the proposed settlement.

21. This conclusion is further compelled by the fact that the class action settlement could result in manifestly inequitable distributions to different classes of claimants and is therefore tainted with impermissible conflicts of interest. If ultimately approved, the proposed settlement of the Federal Actions would purport to cut off the damage claims of all class members in return for a settlement fund of $16.5 million (part of which would go to pay

[6] The Non-Consenting Noteholders are not named plaintiffs in any of the class actions proposed to be settled by the Debtor and, to the extent they are otherwise included in any class thereunder, they intend to exercise their rights to opt out of any settlement reached on behalf of the class.

plaintiffs' lawyers) and 3.5% of the reorganized Debtor's equity. Those class members would include persons who claim damages based of purchase of the Debtor's equity as well as persons who claim damages based on purchases of the Debtor's debt. Class counsel, who represents both sets of claimants, will therefore be called upon to propose a distribution of the settlement fund to both debt claimants and equity claimants, a distribution that, as shown above, cannot be in accordance with the absolute priority principles of the Bankruptcy Code.

22. Perhaps even worse, the proposed settlement and Plan are structured in such a way as to coerce purchasers of Covad debt either to accept the settlement or to lose their damage claims altogether. Even if a Covad noteholder opts out of the settlement, it will still be unable to pursue its securities law damage claims against Covad or its officers and directors because those claims are to be released and discharged under the Plan. The Plan and settlement agreement thus subject plaintiffs' counsel in the Federal Actions to an impermissible conflict of interest. In order to obtain the proposed settlement (and the lawyers' fees to be paid from the settlement fund), plaintiffs' counsel will have effectively coerced the debt holders they purport to represent into giving up their securities law damage claims for the pennies on the dollar offered under the settlement agreement or to receive nothing at all on those claims.

23. This inequitable and fatally tainted settlement calls out for the scrutiny afforded by the plan confirmation process. Rather than approve a rapid settlement which discriminates against certain classes of creditors and which is the product of a blatant conflict of interest, the entire creditor body, an examiner and the Court must have an opportunity to evaluate and comment on the fairness and propriety of the settlement. In particular, they must be given a chance to determine whether the Debtor's insurance proceeds are better applied to the

estate and distributed in accordance with the each party's respective statutory priority of payment. If approved in its current form, certain shareholders and noteholders would receive a greater distribution on their claims than others. In addition, equity holders would once again be preferred at the expense of the noteholders and other unsecured creditors of the Debtor's estate.

24. Here, the Class Action Motion utterly fails to satisfy, let alone address, any factors necessary for the Court to approve the class action settlement. Pursuant to Bankruptcy Rule 9019, which provides the procedure required for court approval of a settlement,[7] the Debtor must provide the Court with enough information regarding the settlement for the Court to determine the probability of success in the underlying actions, the complexity of the actions, the expense, inconvenience and delay attendant to the actions and, most importantly, the paramount interest of the estate's creditors. See In re Martin, 91 F.3d 389 (3d Cir. 1996). In addition and in direct contravention of § 524(e) of the Bankruptcy Code, the proposed settlement would release all creditor claims against non-debtor officers and directors. Rather than address these vital issues, the Debtor simply ignores them in an effort to achieve a quick absolution of liability for its directors and officers. Indeed, the Class Action Motion does not make any disclosure as to the basis for the proposed settlement, the details of the claims asserted, the nature of the defendants' defenses to those claims, whether the settlement is fair and appropriate, how the proceeds of the settlement are to be allocated between creditor and shareholder claims, and numerous other factors that the Court requires in order to evaluate the propriety of the relief

[7] The Debtor has moved to lift the stay to permit the implementation of the class action settlement. Because the settlement fixes recoveries to certain creditors and equity-holders and is thus an integral component of the Debtor's Plan, the settlement must be subject to approval in connection with the plan process. Accordingly, it is premature for the Court to lift the stay now to let the District Court approve this settlement, particularly on the poor showing made by the Debtor, without letting parties in interest examine further into the Debtor reached the class action settlement in the first place.

requested. Until such information is presented, the Court simply cannot conduct a proper hearing to evaluate the merits of the Class Action Motion.

25. Simply put, authorizing the Debtor's settlement of the class action lawsuits and the general releases of its officers and directors contained therein is not only premature, but also legally improper. If the class action settlement and the assumption of the Escrow Agreement are approved, all creditors will suffer the irreversible prejudice of having two critical plan components – the fixing of the distribution to the noteholder class and the release of significant claims against officers and directors – effectively approved without any opportunity to investigate or contest such matters in accordance with the chapter 11 process and in complete violation of their rights under the Bankruptcy Code.

Conclusion

WHEREFORE, for the reasons set forth herein, the Court should deny the Motions. In the alternative, the Court should defer consideration of the relief sought in the Motions until such time as the entire creditor body, an examiner and the Court have an adequate opportunity to consider these issues as part of the plan confirmation process.

Dated: September 6, 2001
Wilmington, Delaware

ROSENTHAL MONHAIT GROSS & GODDESS PA

By: /s/ Kevin Gross
Kevin Gross (ID. No. 209)
Suite 1401 Mellon Bank Center
919 North Market Street
Wilmington, Delaware 19801
Tel: (302) 656-4433
Fax: (302) 658-7567

and

STROOCK & STROOCK & LAVAN LLP
Michael F. Perlis
Curtis C. Mechling
Robin E. Keller
180 Maiden Lane
New York, NY 10038-4982
Tel: (212) 806-5400
Fax: (212) 806-6006

Attorneys for the Non-Consenting Noteholders