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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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In re : Chapter 11
: :
: Case Nos. 02-41729 (REG)
ADELPHIA COMMUNICATIONS :
CORPORATION, et al., : (Jointly Administered)
: :
Debtors. :
: :
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**HEARING TWO REPLY BRIEF OF THE FT. MYERS NOTEHOLDERS
PURSUANT TO THE ORDER IN AID OF CONFIRMATION**

CONFIDENTIAL – FILED UNDER SEAL

The Ft. Myers Noteholders¹ submit this reply brief (the “Reply”) in connection with “Issue Two” of the Order in Aid. In support thereof, the Ft. Myers Noteholders respectfully represent as follows:

PRELIMINARY STATEMENT

The issues relevant to the Issue Two determinations have now been crystallized. The Court has ruled orally that, although Adelpia’s restated general ledgers and the financial reports flowing therefrom are admissible as business records, no presumptive validity will be accorded to these financial records. In addition, the Court noted that any proponent of an intercompany claim will have the burden of proving such claim by a preponderance of the evidence. The ACC Noteholder Committee, as the primary proponent of the intercompany claims in the May 2005 Schedules, will not be able to satisfy that burden as to three identifiable categories of intercompany claims: the Historical Intercompanies, Assumption Intercompanies, and Acquisition and Swap Intercompanies.

The ACC Noteholder Committee takes the sweeping position in its Issue Two opening brief (the “ACC Opening Brief”) that the “review and scrubbing” of the Restatement are sufficient to afford all intercompany claims, however arising, full validity and a priority equal to that of valid third-party claims allowed in these proceedings. Notably absent from the ACC Opening Brief is any discussion of – indeed barely any allusion to – the corporate history of fraud that permeated not simply the operations of Adelpia but more specifically the accounting for such operations as reflected in the intercompany books and records. Indeed, the uncontroverted evidence is clear that the intercompany books were the primary vehicle used by

¹ Capitalized terms used herein without definition are used as defined in the Hearing Two Brief of the Ft. Myers Noteholders Pursuant to the Order in Aid of Confirmation (the “Opening Brief”).

the Rigas Family to perpetrate the fraud and that the Restatement, despite the best efforts of post-petition management, failed to cleanse that fraud from what ultimately became the May 2005 Schedules. While the ACC Noteholder Committee might prefer to close its eyes to the fraud, the other parties in interest in these cases, whose recoveries may be demonstrably and negatively impacted, and the Court cannot.

Nor does the existence of what may be a legitimate centralized cash management system imbue the transactions that are reflected on the records of that system with legitimacy. Notwithstanding the pages of the ACC Opening Brief devoted to cases upholding ordinary course centralized cash management systems, Issue Two does not turn on the question of whether centralized cash management systems can be an appropriate means of managing cash within an integrated corporate family. The answer to that question is clearly yes. Instead, Issue Two turns on the question of whether in this case the entries on the May 2005 Schedules reflect valid intercompany claims that are entitled to treatment *pari passu* with valid, third party unsecured claims. At least as to the Historical Intercompanies, Assumption Intercompanies and Acquisition and Swap Intercompanies, the answer to that question is just as clearly no.² Accordingly, these specific categories of claims should be disallowed and disregarded, or, at minimum, subordinated in the manner described by the Debtors as C1 treatment.

I. THE ASSUMPTION INTERCOMPANIES AND THE ACQUISITION AND SWAP INTERCOMPANIES SHOULD BE DISALLOWED.

As indicated, the burden of proof is on the ACC Noteholder Committee to prove up these specific categories of intercompany claims. The ACC Noteholder Committee, as the

² In light of the fact that no issue has been raised with respect to the disallowance of the Historic Intercompanies, the Ft. Myers Noteholders rest upon the contentions in their Opening Brief that these intercompany claims are inappropriately asserted by and against the Bank of Adelpia and therefore must be disallowed.

proponent of the intercompany claims brought on behalf of the Debtors themselves, stands in the shoes of the insider claimant and must, therefore, also carry the burden of demonstrating the inherent fairness and good faith of the transactions underlying these claims. See, e.g., In re Harford Sands, Inc., 372 F.3d 637, 640 (4th Cir. 2004) (finding that when considering whether to disallow an insider’s claim the burden is on the insider to show the “inherent fairness and good faith” of the transaction); In re Dunes Hotel Assoc., 194 B.R. 994, 1001 (Bankr. D.S.C. 1995) (noting that burden is on the insider to demonstrate good faith and inherent fairness of the transaction).³ In order to satisfy its burden, it will not be enough for the ACC Noteholder Committee to argue that these claims have been cleansed by the Restatement or that they simply are the result of a centralized cash management system and ordinary course lending practices. The weight of the evidence will demonstrate quite the opposite. Instead, the ACC Noteholder Committee must show the fundamental validity of these claims in light of the fraud giving rise to them - a burden it simply cannot meet in this case.

The fundamental underpinning of the first argument in the ACC Opening Brief – that “the scheduled Intercompany Claims arise from the prepetition operation of Adelpia’s centralized cash management system” (ACC Op. Br. at 6) – is simply not true as applied to the Assumption Intercompanies and the Acquisition and Swap Intercompanies. As fully set forth in the Opening Brief, these intercompany claims resulted from the Rigas Family’s misuse of the co-borrowing facilities and improper accounting treatment of acquisitions, both of which devices were used to facilitate fraudulent activity. (Opening Brief at 8-11.) In particular, the

³ Similarly, as noted in the Opening Brief, the ACC Noteholder Committee has the additional burden to demonstrate the inherent fairness and good faith of the transaction in the equitable subordination context. See, e.g., Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 701 (6th Cir. 1977) (noting that the burden is on the insider “not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein” (quoting Pepper v. Litton, 308 U.S. 295, 306 (1939))); In re Adler,

Assumption Intercompanies arose when the Rigas entities would purportedly assume co-borrowing debt and correspondingly charge the Adelpia co-borrowing entity with an intercompany payable for allegedly having removed the debt from the Adelpia entity's balance sheet. (Id. at 9.) While the ACC Noteholder Committee would have the Court find that the Restatement identified all the Assumption Intercompany fraud and incorporated the necessary accounting corrections, in fact, Scott McDonald, the debtors' Chief Accounting Officer, admitted in Hearing One testimony that the effects or "footprints" of this Rigas fraud still flowed through the restated financials to the detriment of the Adelpia co-borrower entities. (Hearing Tr. 5.70:13-5.71:10.)

As an example, the facts of the Century Cable Holdings, LLC ("CCH") Co-Borrowing reclassifications illustrate the fraudulent nature of the Assumption Intercompanies. In April 2000, Adelpia closed on the \$2.48 billion CCH Co-Borrowing Facility with Highland Prestige of Georgia, Inc. ("Highland") as the Rigas co-borrower. After the closing of the CCH Facility, \$1.16 billion of the co-borrowing debt was re-allocated from CCH's books to Highland's books through a series of intercompany entries in an attempt by then-present management to artificially and fraudulently "de-leverage" Adelpia's financial statement. The direct result of this fraudulent accounting was CCH's incurrence of a \$1.16 billion intercompany payable to the Bank of Adelpia.

Subsequently, the Debtors' GAAP restatement process corrected the fraudulent understatement of CCH's full \$2.48 billion liability on the co-borrowing debt. However, the restatement process not only failed to remove the fraudulent \$1.16 billion intercompany payable

277 B.R. 520, 564 (Bankr. S.D.N.Y. 2002) (quoting Mobile Steel and finding that the burden is on the insider "'to prove the good faith of the transaction' and also "'to show its inherent fairness from the viewpoint' of the debtor.'").

from CCH's books, it also improperly recorded a worthless affiliate receivable from Highland (written off due to unlikely repayment). (See Restated 10-K of Adelpia Communications Corporation for the period ended December 31, 2003 at 127.) The Assumption Intercompanies do not, as the ACC Opening Brief would have us believe, reflect a "transfer of value" that cannot be ignored or given no effect whatsoever. (ACC Op. Brief at 19) It is undisputed that the Adelpia co-borrowers were jointly and severally liable on the co-borrowing debt despite the Rigas entities' purported assumption of that debt. Thus, the consideration received for the intercompany payable (the purported assumption) charged against the Adelpia entity was entirely illusory, as conceded by Mr. McDonald in Hearing One. (Hearing Tr. 5.32:9-5.33:7.)

The Restatement is clearly incomplete, and only the disallowance of the Assumption Intercompanies would correct the economic harm caused by the Rigas Family's fraud. Importantly, the transactions at the CCH Facility are representative of the Assumption Intercompanies, which were endemic across the Adelpia structure. If not disallowed, the Assumption Intercompanies would cause significant economic harm to the Century, Olympus and UCA Debtor Groups as well and to the multitude of third party claimants, including the Ft. Myers Noteholders. (See Expert Report of Daniel Scouler, Exhibits 8 and 12.)

Likewise, the Acquisition and Swap Intercompanies arose from the Rigas Family's efforts to defraud their creditors by accounting for the transfer of cable and subscriber systems between the debtor silos as debt rather than equity, by a hybrid of debt and equity, or by whatever means necessary to hide the true financial picture of the numerous Adelpia entities. (Id. at 10.) The Acquisition and Swap Intercompanies arose from non-cash transactions whereby Adelpia's acquired entities were transferred through the corporate structure.

A prime example of the problematic elements of an Acquisition and Swap Intercompany is the accounting for Adelphia's acquisition and subsequent transfer of Cablevision of the Midwest. In November 2000, ACC acquired the assets of Cablevision of the Midwest ("Midwest") for \$503.8 million in ACC stock. These acquired Midwest assets were then transferred to ACC Operations, Inc. in an equity contribution through the operation of a Contribution and Assignment Agreement. Subsequently, ACC Operations, Inc. transferred the Midwest assets to Arahova Communications, Inc. in an equity contribution using another Contribution and Assignment Agreement. However, Arahova Communications, Inc. then transferred the Midwest assets to Century Communications Corp. through an intercompany payable-even though the same form of Contribution and Assignment Agreement was used. By the time the Midwest assets had been transferred to Adelphia of the Midwest Inc., three additional pairs of intercompany balances of \$503.8 million had been created with the Bank of Adelphia.

Intercompany accounting for the transfer of acquired entities through the Adelphia corporate structure was not only inconsistent, but it also frequently disagreed with the form and nature of the legal documentation, the effect of which is to seriously distort the economic reality of the non-cash equity contributions to the detriment of creditors like the Ft. Myers Noteholders.

II. THE PROPRIETY OF CENTRALIZED CASH MANAGEMENT SYSTEMS GENERALLY IS NOT AT ISSUE IN THIS CASE

The ACC Opening Brief is also premised on the faulty assumption that a centralized cash management system that reflects ordinary course cash transactions and other corporate cash management functions somehow sanitizes the entirety of entries reflected on that

system, even in the presence of fraud or in the absence of any legitimate business justification. Thus, the ACC Opening Brief presents a laundry list of functions that Adelphia's cash management system performs that are "typical" of corporate cash management systems generally (id. at 7-8) However, these operations, which address how cash is received, disbursed and accounted for, provide absolutely no basis for treating the Assumption Intercompanies or the Acquisition and Swap Intercompanies *pari passu* with legitimate third-party debt. The movement of cash into and out of the Adelphia corporate system and how that cash is accounted for is irrelevant to an analysis of Assumption Intercompanies and the Acquisition and Swap Intercompanies, which arose from non-cash transactions outside of the normal operations of the cash management system.

The ACC Opening Brief contains a recitation of case after case where courts upheld legitimate cash management systems and legitimate intercompany lending practices, none of which have any bearing on the billions of dollars of identifiable transactions that resulted from the Rigas Family's fraudulent activities. For these transactions, the ACC Noteholder Committee has not cited to any body of caselaw, nor are we aware of any, that stands for the proposition that fraudulent claims or claims resulting from the inequitable conduct of insiders should be treated *pari passu* with third-party debt.

For example, the ACC Opening Brief relies heavily on the Hillsborough Holding Corp. cases. Celotex Corp. v. Hillsborough Holdings Corp. (In re Hillsborough Holdings Corp.), 176 B.R. 223 (M.D. Fla. 1994) ("Hillsborough II"); Hillsborough Holdings Corp. v. Celotex Corp. (In re Hillsborough Holdings Corp.), 166 B.R. 461 (Bankr. M.D. Fla. 1994) ("Hillsborough I") (See ACC Op. Br. at 6-7, 9-11, 13-15.) In the Hillsborough line of cases, the debtor's asbestos claimants sought to pierce the corporate veil and hold the debtor's parent

corporation liable for the subsidiary's asbestos liabilities. On review of the bankruptcy court's decision denying the asbestos claimants' relief, the district court concluded that in order to pierce the corporate veil the claimant was required to "affirmatively prove fraud or deliberate misconduct" under Delaware or Florida law. Hillsborough II, 176 B.R. at 245. In that respect, the court considered whether the prepetition cash management system evidenced improper conduct by the parent and whether intercompany advances should have been recharacterized as equity. Importantly, the court concluded that there was no evidence of fraud. Id. at 251. The debtor's cash management system was consistent with sound business practices. In addition, the court found that the weight of the testimony and evidence presented demonstrated that the intercompany loans were arm's length transactions and bona fide, reiterating the well-settled proposition that "if evidence indicates that an advance otherwise complies with normal business practices and arm's length dealing, a court may properly characterize the advance as a debt." Id. at 248-49.

This case is easily distinguished from Hillsborough, particularly with respect to the Assumption Intercompanies and the Acquisition and Swap Intercompanies. First, the Assumption Intercompanies arose from anything but arm's-length transactions. In particular, they accrued as a result of the Rigas Family's scheme to use Adelphia's corporate funds for their own private purposes and to defraud the public by moving debt off the balance sheet of public reporting companies. The Assumption Intercompanies carry no indicia of arm's length, third-party debt and should be disregarded or, at best, recharacterized or equitably subordinated and treated as equity. The Acquisition and Swap Intercompanies suffer from the same shortcomings. They also were central to the Rigas Family's fraud, were undocumented (or inconsistent with

existing documents) and evidence none of the factors courts look to for arms-length transactions and legitimate third party debt.

CONCLUSION

For the reasons set forth herein and in the Opening Brief, the Ft. Myers Noteholders respectfully request that the Court find that (1) the Assumption Intercompanies, the Acquisition and Swap Intercompanies, the Historic Intercompanies, and all interest accruing thereon be completely disallowed, (2) to the extent the Court determines the intercompany claims are entitled to any distribution in these proceedings, they should be treated as equity or, in the absence of such recharacterization, be afforded C1 treatment, and (3) the Court grant such other and further relief as the Court may deem just and proper.

Dated: February 3, 2006
New York, New York

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Adelphia Communications Corporation, <u>et al.</u>)	Case No. 02-41729 (REG)
)	Jointly Administered
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)	

CERTIFICATE OF SERVICE

I hereby certify that I caused the Hearing Two Reply Brief Of The Ft. Myers Noteholders Pursuant To The Order In Aid Of Confirmation to be served by electronic mail on Participants pursuant to the Court's Order in Aid of Confirmation, Pursuant to Sections 105(a) and 105(d) of the Bankruptcy Code, Establishing Pre-Confirmation Process to Resolve Certain Inter-Creditor Issues, on February 3, 2006.

Dated: New York, New York
February 3, 2006

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