

Delaware (the "Bankruptcy Court") or may be obtained by contacting IKON Document Services, 901 Market Street, Wilmington, Delaware 19801 or by telephone at (302) 777-4500.

PLEASE TAKE FURTHER NOTICE that objections, if any, to the Final Application must be made in writing, filed with the United States Bankruptcy Court for the District of Delaware, 824 Market Street, Wilmington, Delaware 19801, and served so as to be received by 4:00 p.m. Eastern time on **July 11, 2002** by the undersigned counsel for the McLeodUSA Incorporated.

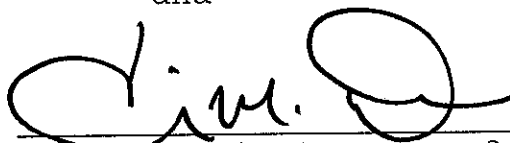
PLEASE TAKE FURTHER NOTICE that if no objections to the Final Application are timely filed and served in accordance with the above procedures, the Bankruptcy Court may enter an order granting the relief requested in the Final Application without further notice or a hearing. If an objection is properly filed and served in accordance with the above procedures, a hearing will be held by the Bankruptcy Court on August 6, 2002 at 9:30 p.m. before the Honorable Ronald Barliant, United States Bankruptcy Judge, 824 Market Street, Wilmington, Delaware 19801. Only those objections made in writing

and timely filed and received will be considered by the
Bankruptcy Court at such hearing.

Dated: Wilmington, Delaware
June 21, 2002

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Attorneys for McLeodUSA Incorporated

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re:)	Chapter 11
)	
McLEODUSA INCORPORATED,)	
Debtor.)	Case No. 02-10288 (EIK)
)	
)	

**FINAL APPLICATION FOR
ALLOWANCE OF FEES AND REIMBURSEMENT OF EXPENSES
OF HOULIHAN LOKEY HOWARD & ZUKIN CAPITAL
AS FINANCIAL ADVISOR TO THE DEBTOR FOR THE PERIOD
FEBRUARY 1, 2002 THROUGH APRIL 15, 2002**

Name of Applicant: Houlihan Lokey Howard & Zukin Capital

Authorized to Provide Professional Services as: Financial Advisor to the Debtor

Retention Date: February 1, 2002
Period for which Compensation is Sought: (1) February 1, 2002 to April 15, 2002 [1]

Amount of Compensation Sought as Actual, Reasonable and Necessary: (1) \$14,114,216.27

Amount of Expense Reimbursement Sought as Actual, Reasonable and Necessary: (1) \$5,667.53

Houlihan Lokey is not seeking any compensation for the preparation of this Application.

This is a(n): _____ monthly _____ interim final application

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE**

In re:)	Chapter 11
)	
McLEODUSA INCORPORATED,)	
Debtor.)	Case No. 02-10288 (EIK)
)	
)	

**FIRST AND FINAL APPLICATION FOR ALLOWANCE OF
FEES AND REIMBURSEMENT OF EXPENSES OF
HOULIHAN LOKEY HOWARD & ZUKIN CAPITAL AS
FINANCIAL ADVISOR TO THE DEBTOR FOR THE PERIOD
FEBRUARY 1, 2002 THROUGH APRIL 15, 2002**

Houlihan Lokey Howard & Zukin Capital (“Houlihan Lokey”), as financial advisor to the Debtor, hereby submits its First and Final Application for Compensation and Reimbursement of Expenses (the “Application”) pursuant to 11 U.S.C. §§ 327(a), 328 and 331, Bankruptcy Rule of Procedure 2016, the Local Rules and Orders of the Bankruptcy Court for the District of Delaware and the procedures for compensation and reimbursement of expenses of professionals (“Fee Procedures Order”) entered by the Court on February 28, 2002. Houlihan Lokey’s Application seeks compensation for financial advisory services performed and expenses incurred during the periods February 1, 2002 through April 15, 2002 (the “Application Period”).

By this Application, Houlihan Lokey moves this Court for an Order approving final compensation in the amount of \$14,114,216.27, and the reimbursement of actual and necessary expenses of \$5,667.53. Pursuant to Local Rule 2016-2(f), this Application is supported by the Certification of Jonathan Cleveland, which is annexed hereto as Exhibit A. In support of this Application, Houlihan Lokey states as follows:

Background

1. On February 1, 2002, (the "Petition Date"), the Debtor filed its respective voluntary petitions for relief under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). Pursuant to sections 1007 and 1108 of the Bankruptcy Code, the Debtor continued to operate their businesses and manage its properties and assets as a debtor in possession. An Official Committee of Unsecured Creditors was appointed on or around February 13, 2002. No trustee or examiner has been appointed in this case.

2. The Company Debtor and its non-debtor affiliates (the "Non-Debtor Affiliates") (collectively, the Debtor and Non-Debtor Affiliates will be referred to as the "McLeodUSA Group") are facilities-based communications providers that, based upon revenue and customer lines in service, are one of the largest competitive local service providers in the United States. The McLeodUSA Group offers integrated communications services including local, long distance, Internet access, data and voice mail services in competition with existing local telephone companies in 25 Midwest, Southwest, Northwest and Rocky Mountain states. The McLeodUSA Group also provides long distance services in all 50 states and derives additional revenue from the sale of advertising and telephone directories and the sale of traditional local telephone company services in east central Illinois and southeast South Dakota.

3. On February 4, 2002, the Debtor filed an application to employ Houlihan Lokey Howard & Zukin Capital as financial advisor (the "Retention Application"). A copy of the Retention Application is annexed hereto as Exhibit B. Pursuant to §§ 327(a) and 328 of the United States Bankruptcy Code and Rules 2014(a), 2016 and 5002 of the Bankruptcy Rules of

Procedure, on February 28, 2002 the Court entered an order approving the Retention Application (the "Retention Order"). A copy of the Retention Order is annexed hereto as Exhibit C.

Terms and Conditions of Compensation of Houlihan Lokey

4. The terms and conditions of Houlihan Lokey's engagement in these cases, which were embodied in the Retention Application and approved by the Court, are based upon Houlihan Lokey's Engagement Letter of October 25, 2001 (the "Engagement Letter"), a copy of which is annexed hereto as Exhibit D. Pursuant to the Engagement Letter, the Debtors agreed to compensate Houlihan Lokey for its work by: (i) paying a monthly fee of \$200,000.00, and (ii) paying a transaction fee equal to equal to fifty one hundredths of a percent (0.50%) of the principal amount and all accrued interest or accreted principal of the Company bond obligations restructured, modified, amended, compromised or forgiven. In addition, the Retention Agreement entitled Houlihan Lokey to receive reimbursement of all reasonable and necessary out-of-pocket expenses.

5. As detailed in the Retention Application, the terms of the Retention Agreement were comparable to the terms of Houlihan Lokey and other financial advisors and investment bankers agreed-upon in similar engagements, both in, and outside of bankruptcy. Moreover, these terms, including the payment of monthly fees, were not only similar to those routinely approved by the courts within this District, but were expressly contemplated by the Bankruptcy Code.

6. Subject to Bankruptcy Court approval, Houlihan Lokey seeks payment for compensation, plus reimbursement of actual and necessary expenses incurred by Houlihan Lokey during the Application Period.

7. By this Application, Houlihan Lokey requests that this Court authorize:
(a) an Final Allowance of compensation for professional services Houlihan Lokey rendered

during the Application Period for the Debtors in the amount of \$14,114,216.27, and (b) the reimbursement of actual and necessary expenses Houlihan Lokey incurred in connection with the rendition of such professional services for the Debtors in the amount of \$5,667.53.

Summary of Services Provided by Houlihan Lokey

8. Houlihan Lokey is a nationally recognized investment banking and financial advisory firm with 9 offices worldwide and with more than 275 professionals. Houlihan Lokey's Financial Restructuring Group, which has worked on this engagement, has a staff of over 75 professionals dedicated to financial restructuring engagements. In this area, Houlihan Lokey has provided financial advice, valuation analyses and investment banking services to debtors, bondholder groups, secured and unsecured creditors, acquirors, employee stock ownership plans, equity holders and other parties involved with financially distressed companies, both in and outside of bankruptcy.

9. During the Application Period, although a number of other professionals have worked on this engagement, the following professionals in Houlihan Lokey's Minneapolis Office have performed substantial services to the Debtor in these cases:

Jeffrey Werbalowsky – Senior Managing Director
Jonathan Cleveland – Director
Stephen Spencer – Senior Associate
Fred Vescio – Financial Analyst

Biographies of these individuals are annexed hereto as Exhibit E.

10. During the Application Period, Houlihan Lokey's work on behalf of the Debtor involved six separate categories of work, which included:

- (a) Strategic Discussions, Planning & Review;
- (b) Financial and Operational Due Diligence;
- (c) Corporate Finance Work;

(d) Financial Analysis and Monitoring;

(e) Correspondence, Meetings and Discussions with Parties-in-interest; and

(f) Case Administration.¹

(a) **Strategic Discussions, Planning & Review.** Houlihan Lokey expended considerable time and effort assisting the Debtor's senior management in their contemplation of various restructuring strategies and alternatives. Houlihan Lokey assisted the Debtors in arriving at the decision to file for chapter 11, with particular energies directed towards negotiating a lock-up agreement with certain of the Debtor's creditors, assisting the Debtor in providing information to and negotiating with the Debtor's pre-petition bank lenders to structure a global restructuring transaction.

During the Application Period, together with the Debtor's senior management team, Houlihan Lokey served as a key negotiator and provided significant input on many strategic initiatives facing the Debtor. In addition to conducting negotiations and mediation between the various parties-in-interest, such services have required many hours of preparation, strategy setting meetings (including with the Debtor's legal counsel, senior management and between Houlihan Lokey professionals) and associated analyses. Some of the major strategic discussions, negotiations and planning & review activities, included the following:

- Advising the Debtors on various strategic alternatives, including determining negotiating dynamics with its various creditors and parties-in-interest
- Advising the Debtor and participating in strategy sessions and negotiations with the parties-in-interest in the cases, to facilitate a timely exit from chapter 11.

¹ While specific work could qualify under more than one of these categories, Houlihan Lokey has assigned each of its various tasks/services to the most representative category. As an example, work performed evaluating projected cash flows would pertain on some basis to all of the categories outlined above (except, perhaps, case administration) and would not be specifically assignable to any one.

- Conferences and meetings among Houlihan Lokey professionals to facilitate strategy sessions and recommendations, with a particular focus on developing a comprehensive business plan for presentation in the Plan and Disclosure Statement.
- Participating in regular conference calls and meetings with the Debtor's board of directors, management and other professionals to discuss and review the above alternatives and tactics as well as pending legal deadlines.

(b) **Financial and Operational Due Diligence.** Prior to the Petition Date and continuing throughout the Application Period, Houlihan Lokey expended considerable effort performing due diligence on the Debtor's financial projections, actual financial results and key operating initiatives. In particular, Houlihan Lokey conducted extensive financial due diligence aimed at supporting the Debtor's decision to file for chapter 11, and worked hand-in-hand with the Debtor to develop, present and support a comprehensive set of financial forecasts for use in a financial restructuring transaction and the exit financing facility. Following the Petition Date, Houlihan Lokey expended considerable energy conducting diligence on the financial performance of the Debtor's existing operations.

Finally, Houlihan Lokey assisted the Debtor's senior management team in preparing for the extensive due diligence requirements of its creditors and other parties-in-interest. In particular, Houlihan Lokey: (i) assisted the Debtor in organizing financial information to facilitate due diligence and (ii) developed detailed due diligence materials for meetings with creditors and other parties-in-interest that assisted the Debtor's creditors in keeping abreast of the financial and operational health of the business.

(c) **Corporate Finance Work.**

Houlihan Lokey has coordinated negotiations with the Debtor's pre-petition bank group to provide exit financing on an expedited basis to ensure that the Debtor satisfy all conditions

necessary to confirm a plan of reorganization. The exit financing facility will be used to provide incremental liquidity to the Debtors once they emerge from bankruptcy.

In addition, Houlihan Lokey performed necessary corporate finance work on an as-needed basis on behalf of the Debtor, including providing updates to the Official Committee of Unsecured Creditors as necessary.

(d) **Financial Analysis and Monitoring.** Houlihan Lokey conducted a variety of analyses that were used in the Plan and Disclosure Statement. Such analyses included financial projections, liquidation analyses, valuation analyses and recovery analyses. In addition, Houlihan Lokey created textual explanations for certain of the preceding analyses for inclusion in the Plan and Disclosure Statement.

Houlihan Lokey performed extensive financial analysis and monitoring activities on behalf of the Debtor, its creditors and various other parties-in-interest. Houlihan Lokey analyzed the Debtor's financial results on a recurring basis, with the goal of identifying and explaining variances to its projections to the creditors, their advisors and other parties-in-interest.

Finally, significant financial analysis and monitoring was performed regarding the Debtor's long-term financial outlook in an effort to augment a comprehensive, pre-existing business plan that served as the foundation of the Debtor's Plan.

(e) **Correspondence, Meeting and Preparation with Parties-In-Interest.** Houlihan Lokey engaged in extensive correspondence and preparation for meetings with various parties-in-interest and the Debtor's other professionals in these chapter 11 cases. Houlihan Lokey has expended significant time and effort (both in-person and via conference call) meeting the due diligence requirements of various parties-in-interest to these chapter 11 cases. In addition, Houlihan Lokey conducted meetings via conference call with parties-in-interest to

provide situational updates.

(f) **Case Administration.** This category includes various services related to chapter 11 non-plan issues, retention matters, addressing Debtor's and counsel questions, chapter 11 procedures, communications and administrative functions and other matters not falling into any of the other categories listed above.

Houlihan Lokey's Application

11. The professional services and related expenses that are the subject of Houlihan Lokey's Application were rendered and incurred in connection with these cases, and in discharge of Houlihan Lokey's professional responsibilities as financial advisor and for the Debtor in their chapter 11 cases. Houlihan Lokey's services have been substantial, necessary, and beneficial to the Debtor and its estates, creditors, and other parties in interest. Houlihan Lokey believes that the fees and expenses requested by their Application are reasonable and necessary -- given the variety and complexity of the issues involved in these cases and the need to act or respond on an expedited basis to those issues -- and are contemplated by the Bankruptcy Code and this Court's Retention Order.

12. A summary of (i) professional fees and (ii) expenses incurred by and payable to Houlihan Lokey during the Application Period is attached hereto as Exhibit F of this Application. All requested expenses are in compliance with Local Rule Number 2016-2. Houlihan Lokey has maintained detailed records of actual and necessary expenses incurred during the Application Period.


13. Pursuant to the Fee Procedures Order, Houlihan Lokey and other professionals retained in these cases are authorized each month to file and serve upon the Debtor and parties identified in the Fee Procedures Order a fee application (the "Fee Application").

14. Accordingly, Houlihan Lokey requests allowance of compensation in the amount of \$14,114,216.27 for financial advisory services rendered during the Application Period, and seeks reimbursement for actual and necessary expenses during the same period in the amount of \$5,667.53, the details of which are set forth in Exhibit F of this Application.

WHEREFORE, Houlihan Lokey requests that the Court enter an Order, substantially in the form of the Order annexed hereto as Exhibit G, allowing compensation for financial advisory services rendered to the Debtor during the Application Period in the amount of \$14,114,216.27 and reimbursement of expenses incurred during the same period in the amount of \$5,667.53, and that the Debtors be ordered to pay to Houlihan Lokey all amounts requested pursuant to the Fee Procedures Order.

Dated: Minneapolis, Minnesota
_____, 2002

HOULIHAN LOKEY HOWARD & ZUKIN CAPITAL

By:  _____
Jonathan Cleveland
Houlihan Lokey Howard & Zukin Capital
Director
(612) 338-2910

Financial Advisor to the Debtor

EXHIBIT A

Certification of Jonathan Cleveland

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In re:

McLEODUSA INCORPORATED

Debtor.

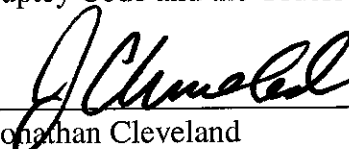
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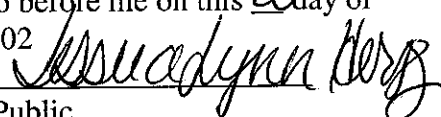
CERTIFICATION OF JONATHAN B. CLEVELAND

1. I am a Director of Houlihan Lokey Howard & Zukin Capital, and I make this certification in accordance with Local Rule 2016-2(f) (the "Local Rule").

2. I have read the Final Application of Houlihan Lokey Howard & Zukin Capital for Compensation and Reimbursement of Expenses for the Period of February 1, 2002 through April 15, 2002 (the "Application").

3. I have read the Local Rule, and believe that the Application complies with the provisions of the Local Rule, the United States Bankruptcy Code and the Orders of this Court.


Jonathan Cleveland
Houlihan Lokey Howard & Zukin Capital
Director
(612) 338-2910

Sworn to before me on this 20 day of
June, 2002

Notary Public

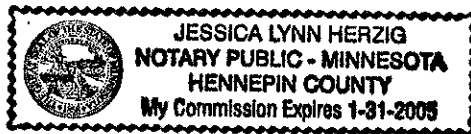


EXHIBIT B

Copy of Retention Application

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

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In re:                :
                    : Chapter 11
                    :
MCLEODUSA INCORPORATED, : Case No. 02-10288 (EIK)
                    :
                    : Hrg. Date: 02/28/02 @ 10:00 a.m.
                    : Obj. Due: 02/23/02 @ 4:00 p.m.
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**APPLICATION FOR ORDER UNDER 11 U.S.C. §§ 327
AND 328 AND FED. R. BANKR. P. 2014 AND 2016
AUTHORIZING THE EMPLOYMENT AND RETENTION OF HOULIHAN
LOKEY HOWARD & ZUKIN CAPITAL AS FINANCIAL ADVISOR**

McLeodUSA Incorporated ("McLeodUSA" or the "Debtor"), debtor and debtor-in-possession in the above-captioned case, submit this application (the "Application") for an order under 11 U.S.C. §§ 327 and 328 and Fed. R. Bankr. P. 2014 and 2016 approving an agreement with Houlihan, Lokey, Howard & Zukin Capital ("Houlihan") appointing it as financial advisor of the Debtor. In support of this Motion, the Debtor relies on the Declaration of Randall Rings in Support of Chapter 11 Petition and First Day Orders, sworn to January 31, 2002, and the Affidavit of Jonathan B. Cleveland in support of this Application (the "Cleveland Declaration"). In further support of this Application, the Debtor respectfully represents as follows:

BACKGROUND

A. The Chapter 11 Filing

1. On January 31, 2002 (the "Petition Date"), the Debtor filed a voluntary petition in this Court for reorganization relief under chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101-1330 (as amended, the "Bankruptcy Code"). The Debtor continues to manage and operate its business as debtor-in-possession pursuant to Bankruptcy Code sections 1107 and 1108.

2. On the Petition Date, McLeodUSA also filed the Plan of Reorganization of McLeodUSA Incorporated (the "Plan") and the Disclosure Statement with Respect to Plan of Reorganization of McLeodUSA Incorporated (the "Disclosure Statement"). In addition, McLeodUSA has filed a separate motion requesting that the Court, among other things, set dates for hearings to approve the Disclosure Statement and McLeodUSA's solicitation procedures and to confirm the Plan. The Debtor has entered this case with substantial liquidity. In total, the Debtor and its affiliated entities have approximately \$140 million at their disposal to fund ongoing operations.

3. No trustee or examiner has been appointed in this chapter 11 case, and no committees have yet been appointed or designated.

B. The Debtor's Business

4. The Debtor and its non-debtor affiliates (the "Non-Debtor Affiliates") (collectively, the Debtor and Non-Debtor Affiliates will be referred to as the "McLeodUSA Group") are facilities-based communications providers that, based upon revenue and customer lines in service, are one of the largest competitive local service providers in the United States. The McLeodUSA Group offers integrated communications services including local, long distance, Internet access, data and voice mail services in competition with existing local telephone companies in 25 Midwest, Southwest, Northwest and Rocky Mountain states. The McLeodUSA Group also provides long distance services in all 50 states and derives additional revenue from the sale of advertising in telephone directories and the sale of traditional local telephone company services in east central Illinois and southeast South Dakota.

5. In 2000, the McLeodUSA Group recognized approximately \$1.4 billion in revenue. As of December 31, 2000, the McLeodUSA Group's extensive network provided service in 800 cities, and had approximately 1.1 million local lines providing service to both business and residential customers. As of the Petition Date, the

McLeodUSA Group had approximately 8,500 employees, of which approximately 170 work for the Debtor.

6. The McLeodUSA Group's operations are structured through three groups of entities whose stock is directly or indirectly held by McLeodUSA. The first group consists of the telecom operating companies and the companies that provide the McLeodUSA Group's directory publication services, and includes McLeodUSA Media Group, Inc. ("Pubco"). The second group of entities consists of entities owned directly or indirectly by CapRock Communications Corp., a facilities-based integrated communications provider acquired by McLeodUSA in December 2000. The third group of entities, which includes Intelispan, Inc. and a single subsidiary, provide virtual private networks and were acquired by McLeodUSA in June 2001.

C. Prepetition Indebtedness

The Credit Agreement and the Third Amendment

7. On May 31, 2000, McLeodUSA entered into \$1.3 billion of Senior Secured Credit Facilities (the "Credit Agreement") with a syndicate of financial institutions (the "Pre-Petition Secured Lenders"). The Credit Agreement consisted of (a) a seven-year senior secured revolving facility with an aggregate principal amount of \$450 million, (b) a seven-year senior secured multi-draw

term loan facility with an aggregate principal amount of \$275 million, and (c) an eight-year single draw senior secured term loan with an aggregate principal amount of \$575 million. The outstanding balance owed under the Credit Agreement is approximately \$1.0 billion.

8. The Pre-Petition Secured Lenders are secured by (a) a first priority pledge of all the capital stock owned by McLeodUSA and the Non-Debtor Affiliates, and (b) a perfected first priority security interest in substantially all of McLeodUSA's tangible and intangible assets and, to the extent of \$100 million, by the substantially all of the assets of each of the Non-Debtor Affiliates. In addition, the Pre-Petition Secured Lenders are secured by telecommunications assets acquired or constructed with proceeds or refinanced from the Credit Facilities.

The Notes

9. In addition to its prepetition secured debt, McLeodUSA has obtained financing from the issuance of a series of unsecured notes. Specifically, McLeodUSA issued the following notes:

- the 10½% Senior Discount Notes issued by McLeodUSA with an accreted value as of January 31, 2002 of approximately \$495,850,024 (the "10½% Notes");

- the 12% Senior Notes issued by McLeodUSA with outstanding principal plus accrued interest as of January 31, 2002 of approximately \$159,750,000 (the "12% Notes");
- the 11½% Senior Notes issued by McLeodUSA with outstanding principal plus accrued interest as of January 31, 2002 of approximately \$216,037,500 (the "11½% Notes");
- the 9¾% Senior Notes issued by McLeodUSA with outstanding principal plus accrued interest as of January 31, 2002 of approximately \$236,273,437 (the "9¾% Notes");
- the 8¾% Senior Notes issued by McLeodUSA with outstanding principal plus accrued interest as of January 31, 2002 of approximately \$309,421,875 (the "8¾% Notes");
- the 9¼% Senior Notes issued by McLeodUSA with outstanding principal plus accrued interest as of January 31, 2002 of approximately \$307,125,000 (the "9¼% Notes");
- the 11% Senior Notes issued by McLeodUSA with outstanding principal plus accrued interest as of January 31, 2002 of approximately \$799,765,625 (the "11% Notes"); and
- the 8½% Senior Notes issued by McLeodUSA with outstanding principal plus accrued interest as of January 31, 2002 of approximately \$518,619,792 (the "8½% Notes").¹

Under the Notes, McLeodUSA collectively owes approximately \$3,042,843,253.

The Preferred Stock

¹ The 10½% Notes, the 11½ % Notes, the 9¾% Notes, the 8¾% Notes, the 9¼% Notes, the 11% Notes and the 8½% Notes are collectively referred to herein as the "Notes." The holder of the Notes will be referred to as the "Noteholders."

10. McLeodUSA has three outstanding series of preferred stock, Series A Cumulative Convertible Preferred Stock, Series D Convertible Preferred Stock and Series E Convertible Preferred Stock (collectively, the "Preferred Stock"). McLeodUSA issued the Series A Cumulative Convertible Preferred Stock in a public offering in August 1999. The 1,149,400 outstanding shares of Series A Cumulative Convertible Preferred Stock have a liquidation preference of approximately \$287 million. In September 1999, McLeodUSA also closed the sale of two series of preferred stock to affiliates of Forstmann Little & Co. (collectively, "Forstmann Little") for a purchase price of \$1 billion. In September 2001, Forstmann Little exchanged these two series of preferred stock for 275,000 shares of Series D Convertible Preferred Stock and 125,000 shares of Series E Convertible Preferred Stock, which have an aggregate liquidation preference of \$1 billion.

D. Events leading to Chapter 11 Filings

11. Earlier this year, it became clear that, due to certain factors, including, but not limited to, complications related to McLeodUSA's rapid growth, a downturn in economic conditions generally and the competitive telecommunications sector in particular, McLeodUSA

was not meeting internal expectations in terms of profitability and cash flow. As a result, on August 1, 2001, McLeodUSA announced a series of steps to strengthen its senior management and position McLeodUSA for future growth. These steps included:

- the addition of Chris A. Davis as the new Chief Operating and Financial Officer;
- the appointment of Theodore J. Forstmann as Chairman of the Executive Committee of the Board of Directors;
- the addition of four current or former CEOs to the Board of Directors; and
- the exchange of certain outstanding preferred stock for the Series D Preferred Stock and the Series E Preferred Stock.

After these initial steps, McLeodUSA initiated a broad strategic and operational restructuring to re-focus its business on its core areas of expertise within its 25-state footprint, improve business discipline and processes and reduce the company's cost structure, all with a goal of eventually developing positive cash flow from operations. Key elements of the operations restructuring include reducing McLeodUSA's employee base, consolidating facilities, reducing capital expenditures, selling certain non-core assets and de-emphasizing certain unprofitable services.

12. The circumstances that prompted the operational restructuring have adversely affected McLeodUSA's revenue growth, profitability and cash flow and have raised questions about McLeodUSA's liquidity position. Given the magnitude of the operational restructuring, particularly in light of the uncertain general economic environment and the challenging conditions facing competitive telecommunications companies, prudence dictated that McLeodUSA address its highly leveraged balance sheet and develop a restructuring plan to reduce its debt load.

13. Beginning in mid-October of 2001, McLeodUSA started considering strategies to deleverage its capital structure. At such time, McLeodUSA began discussions with Forstmann Little regarding the possibility that it would inject new capital into McLeodUSA to facilitate such a restructuring. Almost concurrently, McLeodUSA formed a special committee of its Board of Directors, comprised of persons not affiliated with Forstmann Little and not members of McLeodUSA's management, and retained outside advisors to assist in exploring alternatives for a restructuring.

14. With the assistance of outside advisors, McLeodUSA's management and the special committee engaged in extensive negotiations with Forstmann Little and the

Pre-Petition Secured Lenders to sponsor a comprehensive transaction that would result in a substantial deleveraging of McLeodUSA. On December 3, 2001, McLeodUSA issued a press release concerning the restructuring agreement (the "Restructuring") which had been reached with the Pre-Petition Secured Lenders and Forstmann Little.

15. Under the terms of the proposed Restructuring: (a) holders of the Notes were to receive their pro rata share of \$560 million in cash and shares of Class A Common Stock representing approximately 14% of McLeodUSA's outstanding common stock, (b) holders of the Preferred Stock and the Class A Common Stock were to receive the remaining shares of Class A Common Stock.

16. Prior to the announcement, McLeodUSA and the Pre-Petition Secured Lenders agreed to amend (the "Third Amendment") the Credit Agreement to permit the Restructuring. Under the Third Amendment, the Prepetition Lenders waived (a) any bankruptcy and payment cross-defaults with respect to the Notes (as defined below) that may arise in connection with the Restructuring; (b) covenants respecting sales of assets in order to allow the sale of Pubco and use the proceeds of the sale to redeem the Notes (as defined below); and (c) certain

other covenants and provisions of the Credit Agreement that would have restricted McLeodUSA's ability to enter into various transactions necessary to consummate the Restructuring.

17. Funding for the Restructuring was to have come from the sale of Pubco to Forstmann Little for \$535 million and a \$100 million new money investment from Forstmann Little. The stock purchase agreement with Forstmann Little for the sale of Pubco provided McLeodUSA with the right to terminate the agreement in order to enter into an alternative agreement with a third party for the sale of Pubco at a higher price, subject to certain conditions. In consideration for the \$100 million new money investment, Forstmann Little was to have received new preferred stock and warrants convertible into McLeodUSA Class A Common Stock.²

18. Following the issuance of the press release announcing the Restructuring, Credit Suisse First Boston, retained in connection with the sale of Pubco, continued marketing Pubco and, after an auction, procured an agreement with the Yell Group Limited ("Yell") to sell

² Since the press release, and as discussed more fully below, the terms of the Restructuring have changed in various respects during McLeodUSA's extensive and continuing negotiations with Forstmann Little and representatives of the Notes.

Pubco to Yell for \$600 million, an increase of \$65 million over the purchase price offered by Forstmann Little. If the sale to Yell does not close by April 30, 2002, however, the purchase price will be reduced \$200,000 a day through August 1, 2002.

19. In addition, holders of a sizeable portion of the Notes formed an ad hoc committee (the "Noteholder Committee"). The Noteholder Committee then retained Milbank, Tweed, Hadley & McCloy LLP and Chanin Capital Partners LLC as professionals to assist it in connection with the Restructuring.

20. After the Noteholder Committee indicated that it did not favor the terms of the Restructuring, McLeodUSA entered into extended negotiations with the Noteholder Committee and Forstmann Little regarding an amendment of the Restructuring's terms. On January 31, 2002, McLeodUSA reached an agreement with the Noteholder Committee and Forstmann Little the terms of which are set forth in the Plan filed simultaneously with this case. By way of lock-up agreements, the members of the Noteholder Committee and Forstmann Little have agreed to vote to accept the Plan.

E. The Plan of Reorganization

21. The Plan is the result of extensive negotiations among the Debtor, the Pre-Petition Secured Lenders, Forstmann Little and the Noteholder Committee and calls for Forstmann Little to invest \$175 million (the "Forstmann Little Investment") in McLeodUSA. In exchange for the Forstmann Little Investment, Forstmann Little will receive (a) 22.7778% of the New Common Stock on a fully diluted basis at closing (after giving effect to the Recapitalization, but prior to the exercise of the Warrants and management options) and (b) New Warrants to purchase an aggregate of 6.0% of the New Common Stock for an aggregate purchase price of \$30 million and with terms identical to the New Warrants that will be issued to the Noteholders under the Plan.

22. The Plan provides that all claims against and interests in McLeodUSA that exist on the Petition Date are divided into nine classes, exclusive of certain claims, including administrative claims and priority tax claims, which are not required to be classified. The claims of the Pre-Petition Secured Lenders, other secured claims, non-tax priority claims and general unsecured claims will be unimpaired and receive a 100% recovery.

23. Under the Plan, the Noteholders, in full and complete satisfaction of McLeodUSA's obligations under the Notes, will receive up to:

- \$670 million in cash (subject to adjustment of \$200,000 per day through August 1, 2002 if the sale of Pubco closes after April 30, 2002), in part from the sale of Pubco and Forstmann Little's new money investment, which will be applied to the Notes;
- \$175 million New Convertible Preferred Stock, convertible into 15.0% of the new common stock to be issued under the terms of the Plan (the "New Common Stock") on a fully diluted basis after giving effect to the recapitalization of the Debtor, but prior to the exercise of the New Warrants and management options (as more particularly described in the Plan);
- New Warrants to purchase 6% of the New Common Stock for an aggregate purchase price of \$30 million on a fully diluted basis after giving effect to the recapitalization of the Debtor and the exercise of the New Warrants but prior to the exercise of any management option, on a fully diluted basis; and
- the ability to designate a member of McLeodUSA's board of directors.

24. In addition, the Preferred Stock will receive the following percentages of New Common Stock on a fully diluted basis after giving effect to the recapitalization of the Debtor, but prior to the exercise of the New Warrants and management options: Series A Cumulative Convertible Preferred Stock will 10.3682% of the New Common Stock; Series D Convertible Preferred Stock will receive 24.0625% of the New Common Stock; and Series

E Convertible Preferred Stock will receive 10.9375% of the New Common Stock. Under the Plan, holders of Class A Common Stock will receive 16.8540% of the New Common Stock on a fully diluted basis after giving effect to the recapitalization of the Debtor, but prior to the exercise of the New Warrants and management options.

25. Also in connection with the Plan, on January 29, 2002, McLeodUSA entered into a commitment letter with a syndicate of financial institutions for a five year \$110,000,000 Senior Secured Revolving Credit Facility (the "New Credit Facility") effective upon the consummation of the Plan. McLeodUSA has the ability to increase the size of the New Credit Facility to \$160,000,000. The New Credit Facility will be secured by (1) a first priority pledge of all the capital stock owned by McLeodUSA and the Non-Debtor Affiliates (other than certain excluded subsidiaries), and (2) a perfected first priority security interest in substantially all the tangible and intangible assets owned by McLeodUSA and the Non-Debtor Affiliates (other than certain excluded subsidiaries).³

³ The description of the New Credit Facility is merely a summary of the terms. In all events, the terms of the New Credit Facility will be governed by the loan documents entered into in connection with the New
(continued...)

26. The Plan does not directly involve the Non-Debtor Affiliates or their businesses. Because the Non-Debtor Affiliates are not directly obligated under or guarantors of the Notes, there is no need to include the Non-Debtor Affiliates as proponents of the Plan.

RELIEF REQUESTED

27. By this Application, the Debtor seeks entry of an order authorizing them to retain and employ Houlihan as the Debtor's financial advisor (the "Financial Advisor") in this chapter 11 case.

BASIS FOR RELIEF

28. The Debtor understands that Houlihan provides a broad range of corporate advisory services, including services pertaining to: (i) general financial advice, (ii) advice regarding capital restructuring and financing alternatives, and (iii) advice regarding mergers, acquisitions, and divestitures.

29. The Debtor seeks to retain Houlihan as their Financial Advisor because, among other things, the Debtor believes that (i) Houlihan and its senior professionals have an excellent reputation for providing high quality financial advisory services to debtor and credi-

³ (...continued)
Credit Facility.

tors in bankruptcy reorganizations and other debt restructurings, (ii) Houlihan has extensive knowledge of the Debtor's financial and business operations, its financial history and the industry in which it operates and (iii) Houlihan assisted the Debtor in formulating the restructuring that resulted in the formulation of the Plan and Disclosure Statement.

30. In addition, the Debtor believes that Houlihan and its senior professionals have extensive experience in the reorganization and restructuring of troubled companies, both out-of-court and in chapter 11. The Debtor understands that Houlihan has advised debtor, secured and unsecured creditors, equity constituencies and bondholders in many major bankruptcy cases and out-of-court restructurings.

31. Specifically, the Debtor understands that the professionals of Houlihan have been employed as financial advisors in a number of troubled company situations, including, among others, Paging Network, ICG Communications, Pathmark, Ameriserve, AEI Resources, United Artists, Northpoint. Thus, the Debtor believes that Houlihan is well qualified to perform the work required of it in this Chapter 11 case.

32. The Debtor has employed Houlihan, through their counsel, as its Financial Advisors in connection with, among other things, the commencement and execution of this Chapter 11 case, the arrangement of various financing (including debtor-in-possession financing), and assistance in the Debtor's formulation of their business plan. Should this Court approve the retention of Houlihan as Financial Advisor, Houlihan will continue, without interruption, to perform services for the Debtor as provided below.

SERVICES TO BE RENDERED

33. In its capacity as the Debtor's Financial Advisor, the Debtor understands that Houlihan is prepared to perform the following postpetition services (collectively, the "Financial Advisory Services"):

- a. advise the Debtor generally of available capital restructuring and financing alternatives, including recommendations of specific courses of action and assist the Debtor with the design of alternative Transaction structures and any debt and equity securities to be issued in connection with a Transaction;
- b. assist the Debtor with the development, negotiation and implementation of a Transaction, including participation as a representative of the Debtor in negotiations with creditors and other parties involved in a Transaction;

- c. assist the Debtor in valuing the Debtor and/or, as appropriate, valuing the Debtor's assets or operations; provided that any real estate or fixed asset appraisals needed would be executed by outside appraisers;
- d. provide expert advice and testimony relating to financial matters related to a Transaction, including the feasibility of any Transaction, the valuation of any securities issued in connection with a Transaction, and any other matter as to which Houlihan Lokey is rendering services hereunder;
- e. generally advise the Debtor as to potential mergers or acquisitions, and the sale or other disposition of any of the Debtor's assets or business and, in particular, advise the Debtor as to the execution of a merger, acquisition, sale or other disposition in the context of a reorganization or restructuring of the Debtor's capital structure;
- f. advise the Debtor as to any potential financings, either debt or equity;
- g. prepare proposals to creditors, employees, shareholders and other parties-in-interest in connection with any Transaction;
- h. assist the Debtor's management with presentations made to the Debtor's board of directors regarding the transaction and/or other issues related to the Debtor's contemplated reorganization; and
- i. render such other financial advisory and services as may be mutually agreed upon by Houlihan Lokey and the Debtor.

34. If the Debtor seeks to have Houlihan perform any services other than the Financial Advisory Services, the Debtor will seek approval of such services by filing a supplemental Application seeking authorization to retain Houlihan to do so. Until such a supplemental Application is filed and approved by the Court, Houlihan will not be authorized to provide such services to the Debtor and the Debtor will not compensate or indemnify Houlihan for any such services.

DISINTERESTEDNESS OF PROFESSIONALS

35. To the best of the Debtor's knowledge, information, and belief, Houlihan has no connection with, and holds no interest adverse to, the Debtor, its creditors, or any other party in interest, or its respective attorneys or accountants, or the Office of the United States Trustee or any person employed in the Office of the United States Trustee, in the matters for which Houlihan is proposed to be retained, except as disclosed in the Werbalowsky Declaration.

36. To the best of the Debtor's knowledge, Houlihan is a "disinterested person", as such term is defined in Bankruptcy Code section 101(14) and as required under Bankruptcy Code section 327(a). The

Werbalowsky Declaration, executed on behalf of Houlihan in accordance with Bankruptcy Code section 327(a) and Bankruptcy Rule 2014, is filed concurrently herewith. The Debtor's knowledge, information, and belief regarding the matters set forth in this Application are based on, and are made in reliance upon, the Werbalowsky Declaration.

37. The Debtor, through its counsel, initially retained Houlihan on October 19, 2001 (the "Engagement Agreement"). Pursuant to the Engagement Agreement, the Debtor paid Houlihan an aggregate amount of approximately \$819,967.55 during the prepetition period, which included full payment for all prepetition fees and expenses. Accordingly, Houlihan is not a prepetition creditor of the Debtor.

38. The Debtor submits that the appointment of Houlihan on the terms and conditions set forth herein is in the best interests of the Debtor, its creditors and all parties-in-interest.

PROFESSIONAL COMPENSATION

39. As more fully described in the Engagement Agreement, the Debtor has been advised that fees for the services rendered in these cases will be:

- a. A monthly fee of \$200,000 (the "Monthly Fee"), due and payable in

advance of the 19th day of each month;

- b. A transaction fee (the "Transaction Fee") equal to fifty one hundredths of a percent (.50%) of the principal amount and all accrued interest or accreted principal of the Company Bond Obligations restructured, modified, amended, compromised or forgiven (as more fully described in the Engagement Agreement). The Transaction Fee will be reduced by the amount of the Monthly Fee paid to and received by Houlihan beginning with the fourth Monthly Fee paid to and received by Houlihan and each Monthly Fee paid to and received by Houlihan thereafter.

40. Houlihan will also seek reimbursement for all necessary and reasonable out-of-pocket expenses incurred in connection with this engagement, including, but not limited to, travel and lodging, direct identifiable data processing and communication charges, courier services and other necessary expenditures, as further described in the Engagement Agreement.

41. The Debtor understands that the fee structure described above contemplates fees comparable to those generally charged by financial advisory firms of similar stature to Houlihan and for comparable engagements, both in and out of court.

42. In accordance with the terms of the Engagement Agreement, the Debtor also seeks approval of the

fee structure described herein, pursuant to Bankruptcy Code section 328. That section provides, in relevant part, that a debtor "with the court's approval, may employ or authorize the employment of a professional person under section 327 . . . on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis." 11 U.S.C. § 328(a).

43. Bankruptcy Code section 328(a) therefore permits the Court to approve the fee structure proposed in the Engagement Agreement in connection with the Debtor's retention of Houlihan. The Debtor understands that this fee structure is reasonably based on the customary compensation charged by comparably skilled practitioners in cases other than Chapter 11 cases, as well as cases under Chapter 11, and has been approved and implemented in Chapter 11 cases. For these reasons, the fee structure should be approved.

INDEMNIFICATION PROVISIONS

44. As part of the compensation payable to Houlihan under the terms of the Engagement Agreement, the Debtor has agreed to certain indemnification and contribution obligations, as described in Exhibit A to the Engagement Agreement.

FEE APPLICATIONS

45. Pursuant to section 331 of the Bankruptcy Code, the Bankruptcy Rules, the Local Rules and the Orders of this Court, Houlihan Lokey will apply to the Court for interim and final allowance of compensation and reimbursement of expenses. Because Houlihan Lokey will be compensated on a fixed monthly fee and certain transaction fees, Houlihan Lokey should not be required to maintain or provide detailed time records in connection with any of its applications.

46. Such applications for fees and expenses will be paid by the Debtor, pursuant to the terms of the Engagement Agreement, upon approval by the Court.

JURISDICTION

47. Notwithstanding any provision in the Engagement Agreement to the contrary, with respect to Houlihan's pre-bankruptcy conduct and its provision of postpetition services, including the Financial Advisory Services, Houlihan has agreed to irrevocably and unconditionally submit to the exclusive jurisdiction of this Court over any suit, action or proceeding arising out of or relating to the Engagement Agreement or the Order attached hereto, and over the approval of its requests for any fees and expenses (including any request for


indemnification) accruing through confirmation of a plan of reorganization in this Chapter 11 case or, in the event that no plan of reorganization is confirmed in the cases, fees and expenses accruing prior to the last day of Houlihan's employment pursuant to the Engagement Agreement. This Court will retain jurisdiction to construe and enforce the terms of the Application, the Engagement Agreement, and the proposed Order attached hereto.

48. No previous request for the relief sought in this Application has been made to this Court or any other court.

WHEREFORE, the Debtor respectfully requests that the Court enter an order (i) approving the Engagement Agreement and appointing Houlihan as Financial Advisor of the Debtor and (ii) granting such other and further relief as is just and proper.

Dated: January 31, 2002

McLeodUSA Incorporated,
Debtor and Debtor-in-Possession

By: 
Randall Rings
Group Vice President, Secretary and
General Counsel

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

----- x
 In re: : Chapter 11
 :
 MCLEODUSA INCORPORATED, : Case No. 02-____ (____)
 :
 Debtor. :
 :
 ----- x

**AFFIDAVIT OF JONATHAN B. CLEVELAND IN SUPPORT OF APPLICATION
FOR ORDER AUTHORIZING THE EMPLOYMENT OF HOULIHAN LOKEY
HOWARD & ZUKIN FINANCIAL ADVISORS, INC. AS FINANCIAL ADVISOR
PURSUANT
TO §§ 328(a) AND 1103 OF THE BANKUPRCY CODE**

STATE OF MINNESOTA)
) SS
COUNTY OF HENNEPIN)

Pursuant to Federal Rule of Bankruptcy Procedure 2014(a), Jonathan B.

Cleveland being duly sworn, deposes and says:

1. I am a Director of Houlihan Lokey Howard & Zukin Financial Advisors, Inc. ("Houlihan Lokey") and am duly authorized to make this Affidavit on behalf of Houlihan Lokey. I make this Affidavit on behalf of Houlihan Lokey in support of the Application of McLeodUSA, Inc., ("McLeodUSA" or "The Company") for an Order Authorizing The Employment and Retention of Houlihan Lokey as Financial Advisor (the "Application"). The facts set forth in this Affidavit are personally known to me, and if called as a witness, I could and would testify thereto. Unless otherwise defined, all capitalized terms used herein have the meanings given to them in the Application.

2. Houlihan Lokey provides investment banking, valuation and financial advisory services from 11 offices in the United States, Canada and Asia. Houlihan Lokey's Financial Restructuring Group, which has over 60 dedicated professionals, is one of the leading advisors and investment bankers to debtors, bondholder groups, secured and unsecured creditors, acquirers and other parties-in-interest involved in financially troubled companies, both in and outside of bankruptcy. In this role, I, and other professionals employed by Houlihan Lokey, have been involved, and are currently engaged in, some of the largest restructuring engagements in the United States, including representing the company or the debtor in matters involving *Covad Communications, Inc.*, *Dairy Mart Convenience Stores, Inc.*, *Worldtex, Inc.* and *Stage Stores, Inc.*, while representing official creditor committees in *Armstrong Holdings, Inc.*, *Pillowtex Corp.*, *Laidlaw, Inc.* and *AMF Worldwide, Inc.*

3. Houlihan Lokey has agreed to provide financial advisory services to the Company in the above-captioned Chapter 11 case before this Court, pursuant to the terms and conditions of the Engagement Letter dated October 18, 2001, between McLeodUSA and Houlihan Lokey (the "Engagement Letter"). A copy of the Engagement Letter is attached hereto as Exhibit A. No agreement exists to share any compensation received by Houlihan Lokey for its services with any person or firm.

4. The terms and conditions of the Engagement Letter were heavily negotiated between McLeodUSA, its legal counsel and Houlihan Lokey, and reflected the parties' mutual agreement as to the substantial efforts that will be required in this engagement. As is customary in similar engagements, both in and outside of bankruptcy, the Engagement Letter provides for Houlihan Lokey to receive a Monthly

Fee and a Transaction Fee (as defined in the Engagement Letter). Taking into account the complex nature of this engagement, the terms contained in the Engagement Letter are similar to the terms agreed to by Houlihan Lokey and other financial advisory firms in similar restructuring engagements, both in and outside of bankruptcy.

5. Houlihan Lokey is a "disinterested person" as that term is defined in Section 101(14) of the Bankruptcy Code in that Houlihan Lokey;

- a. is not a creditor, equity security holder or insider of the Debtor;
- b. is not and was not an investment banker for any outstanding security of the Debtor;
- c. has not been, within three (3) years before the date of the filing of the Debtor's Chapter 11 petition, (i) an investment banker for a security of the Debtor, or (ii) an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the Debtor; and
- d. is not and, was not, within two (2) years before the date of the filing of the Debtor's Chapter 11 petition, a director, officer, or employee of the Debtor or of any investment banker as specified in subparagraph (b) or (c) of this paragraph.

6. To the best of my knowledge, information and belief formed after reasonable inquiry, other than in connection with these cases and as set forth in paragraph 7, neither I, Houlihan Lokey and its affiliates nor any of our professionals or employees have any connection with the Debtor, its creditors, any other party with an actual or potential interest in this Chapter 11 case, the Debtor's respective attorneys, accountants and other professionals, the United State Trustee or the United States Bankruptcy Court; specifically:

- a. From time to time, Houlihan Lokey has provided services, and likely will continue to provide services, to certain creditors of the Debtor and various other parties adverse to the Debtor in matters unrelated to this Chapter 11 case. As described below, however, Houlihan Lokey has undertaken a detailed search to determine, and to disclose, whether it has been employed by any significant creditors (including banks), equity security holders, insiders or other parties-in-interest in such unrelated matters.
- b. Houlihan Lokey provides services in connection with numerous cases, proceedings and transactions unrelated to this Chapter 11 case, including representing debtors and creditors' committees in Chapter 11 proceedings and in out-of-court restructurings. These unrelated matters involve numerous attorneys, professionals and creditors, some of whom are attorneys, professionals and creditors of the Debtor in this Chapter 11 case.
- c. Houlihan Lokey personnel may have business associations with certain creditors of the Debtor unrelated to these Chapter 11 cases. In addition, in the ordinary course of its business, Houlihan Lokey will work with and engage counsel or other professionals in unrelated matters who now represent, or in the future may represent, creditors or other interested parties in this Chapter 11 case;
- d. Houlihan Lokey has thousands of clients, past and present, who are located throughout the United States, Asia and Europe, in a variety of industries, including certain parties who are identified as creditors of the Debtor. As far as I have been able to determine, however, Houlihan Lokey has not advised any of these parties, or any other party-in-interest in connection with this Chapter 11 case; and

- e. Houlihan Lokey is affiliated with two investment funds, Sunrise Capital Partners, LP and Century Park Capital Partners, LP. While neither of these funds have any investments in the Debtor, it is possible that they may have made, or currently hold investments in certain of the creditors in this Chapter 11 case. Houlihan Lokey will continue its review of any potential investments in such creditors, and will supplement this Affidavit if necessary.

7. Pursuant to the Engagement Letter, the Debtor paid Houlihan an aggregate amount of approximately **\$819,967.55** during the prepetition period, which included full payment for all prepetition fees and expenses. Accordingly, Houlihan is not a prepetition creditor of the Debtor.

8. To determine its relationship with parties-in-interest in this case, Houlihan Lokey researched its client databases to determine whether it has any relationships with the following entities (collectively, the "Interested Parties"), that were identified to Houlihan Lokey on a list supplied by Skadden, Arps, Slate, Meagher & Flom LLP, counsel to The Company:

- a. the Debtor and its non-debtor affiliates;
- b. the directors and officers of the Debtor;
- c. the 20 largest unsecured creditors of the Debtor;
- d. the attorneys and other professionals of the Debtor;
- f. 5% shareholders of the Debtor;
- g. benefit providers; and

h. other potentially adverse parties.

To the extent that Houlihan Lokey's research of its relationships with the Interested Parties indicated that Houlihan Lokey has provided or is providing services, or has any relationship to any of these entities in matters unrelated to these Chapter 11 cases, Houlihan Lokey has so indicated on the attached Schedule 1.

9. To the best of my knowledge, information and belief, Houlihan Lokey is disinterested and holds no materially adverse interest as to the matters upon which Houlihan Lokey is to be retained. To the extent I discover any facts bearing on the matters described herein during the period of Houlihan Lokey's retention, I will supplement the information contained in this Affidavit.

10. Houlihan Lokey will apply to the Court for payment of compensation and reimbursement of expenses in accordance with the applicable provisions of the Bankruptcy Code, the Bankruptcy Rules, the Local Rules of this Court and the Engagement Letter, and pursuant to any additional procedures that may be established by the Court in this case. Because Houlihan Lokey will be compensated on a fixed monthly basis with a potential Transaction Fee, and as Houlihan Lokey does not have the requisite systems in place to record its time, Houlihan Lokey should not be required to maintain or provide detailed time records in connection with any of its fee applications.

Dated: January 29, 2002

Jonathan B. Cleveland
Jonathan B. Cleveland

Sworn to and subscribed to before me on this 29 day of January, 2002.

Jessica Lynn Herzig
Notary Public
My Commission Expires: 1/31/05

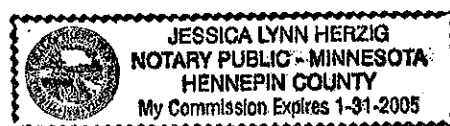


EXHIBIT C

Copy of Retention Order

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

-----X
: ;
In re: : Chapter 11
: ;
MCLEODUSA INCORPORATED, : Case No. 02-10288 (EIK)
: ;
Debtor. : Hrg. Date: 02/28/02 @ 10:00 a.m.
: Obj. Due: 02/21/02 @ 4:00 p.m.
-----X

ORDER UNDER 11 U.S.C. §§ 327
AND 328 AND FED. R. BANKR. P. 2014 AND 2016
AUTHORIZING THE EMPLOYMENT AND RETENTION OF HOULIHAN
LOKEY HOWARD & ZUKIN CAPITAL AS FINANCIAL ADVISOR

This matter having come before the Court on the application, dated February 4, 2002 (the "Application")¹ of McLeodUSA Incorporated ("McLeodUSA"), debtor and debtor-in-possession in the above-captioned case (the "Debtor"), for an order under 11 U.S.C. §§ 327(a), 328 and Fed. R. Bankr. P. 2014, approving the Debtor's agreement with Houlihan Lokey Howard & Zukin Capital ("Houlihan") appointing Houlihan as financial advisor of the Debtor (the "Financial Advisor"); and upon the Affidavit of Jonathan B. Cleveland in Support of the Application (the "Cleveland Declaration"); and the Court being

¹ Unless otherwise defined, capitalized terms used herein shall have the meanings ascribed to them in the Application.

satisfied with the representations made in the Cleveland Declaration that Houlihan represents no interest adverse to the Debtor's estate with respect to the matters upon which Houlihan is to be engaged, that Houlihan is a "disinterested person" as that term is defined in Bankruptcy Code section 101(14), as modified by Bankruptcy Code section 1107(b), and that Houlihan's appointment is necessary and would be in the best interests of the Debtor's estate; and it appearing that proper and adequate notice has been given and that no other or further notice is necessary; and upon the record herein; and after due deliberation thereon; and good and sufficient cause appearing therefor, it is hereby
ORDERED, ADJUDGED AND DECREED THAT:

1. The Application be, and it hereby is, granted.

2. Pursuant to Bankruptcy Code sections 327(a) and 328(a) and Bankruptcy Rules 2014 and 2016, the Debtor is authorized to employ and retain Houlihan as its Financial Advisor on the terms set forth in the Application, this Order and the Engagement Agreement, to the extent the Engagement Agreement is consistent with the Application and this Order, with the exception that the Transaction Fee shall now be defined as follows:

A transaction fee (the "Transaction Fee") equal to fifty one hundredths of a percent (0.50%) of the principal amount and all accrued interest or accreted principal of the Company Bond Obligations restructured, modified, amended, compromised or forgiven (as more fully described in the Engagement Agreement). The Transaction Fee will be reduced by: (i) the amount of the "Monthly Fee" paid to and received by Houlihan beginning with the fourth Monthly Fee paid to and received by Houlihan and each Monthly Fee paid to and received by Houlihan thereafter; and (ii) a fixed amount of \$500,000

3. Pending the ruling from the United States Court of Appeals for the Third Circuit of the District Court's decision in United Artists Theatre Company, et al., Case. No. 00-1351, Houlihan reserves its right to request indemnification pursuant to the terms and conditions of the Engagement Agreement on notice, and the United States Trustee reserves its right to object to any such request for indemnification.

4. Notwithstanding any provision in the Engagement Agreement to the contrary, with respect to Houlihan's pre-bankruptcy conduct and its provision of postpetition services, including the Financial Advisory Services, Houlihan hereby irrevocably and unconditionally submits to the exclusive jurisdiction of this Court over any suit, action or proceeding arising out of or relating to the Engagement Agreement or this Order, and over the approval of its requests for any fees and expenses (in-

cluding any request for indemnification) accruing through confirmation of a plan of reorganization in this Chapter 11 case or, in the event that no plan of reorganization is confirmed in the case, fees and expenses accruing prior to the last day of Houlihan's employment pursuant to the Engagement Agreement. This Court will retain jurisdiction to construe and enforce the terms of the Application, the Engagement Agreement, and this Order.

5. Houlihan shall file interim and final fee applications for allowance of its compensation and expenses with respect to its services with the Court in accordance with applicable provisions of the Bankruptcy Code, Bankruptcy Rules, Local Rules and orders of the Court, provided, however, that Houlihan shall not be required to maintain detailed time records.

6. The Debtor is authorized to pay Houlihan's monthly fees and to reimburse Houlihan for its costs and expenses, as detailed in the Engagement Agreement.

Dated: February 22, 2002

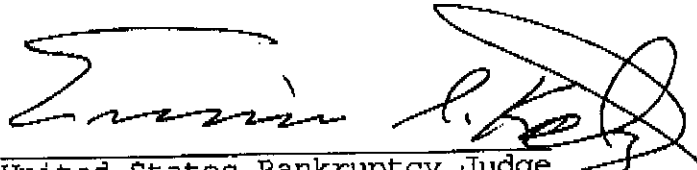

United States Bankruptcy Judge

EXHIBIT D

Copy of Engagement Letter



HOULIHAN LOKEY HOWARD & ZUKIN

FINANCIAL ADVISORS

www.hlh.com

Personal and Confidential

October 25, 2001

Ms. Chris A. Davis
Chief Operating and Financial Officer
McLeodUSA, Inc.
6400 C Street SW, PO Box 3177
Cedar Rapids, Iowa 52406

Dear Chris:

Thank you for selecting Houlihan Lokey Howard & Zukin Capital ("Houlihan Lokey") to serve as the financial advisor to McLeodUSA, Inc. (collectively, with its subsidiaries and affiliates, the "Company"). This letter and the attached Standard Terms of Engagement, which are incorporated herein by this reference (collectively, the "Agreement"), set forth our mutual understanding and agreement as to the terms of our engagement. If appropriate in connection with performing its services for the Company hereunder, Houlihan Lokey may utilize the services of one or more of its affiliates, including but not limited to Houlihan Lokey Howard & Zukin Financial Advisors Inc., in which case the references herein to Houlihan Lokey shall include such affiliates.

1. **Scope of Engagement.** Houlihan Lokey will assist the Company as its financial advisor and agent in connection with any Restructuring Transaction and such related services as the Company requires hereunder. Houlihan Lokey will be the Company's financial advisor on a Restructuring Transaction (the "Restructuring"). Upon execution of this Agreement and receipt of the initial Monthly Fee, Houlihan Lokey will commence its initial review of the Company's financial position, financial history, operations, competitive environment, and assets to assist the Company in determining the best means to implement the most appropriate Restructuring, subject to approval by the Board of Directors of the Company. In connection with our role as your financial advisor, we would expect to, as requested:
 - a. Evaluate the Company's strategic options based upon our discussions with the Company's management team and legal advisors;
 - b. Advise the Company generally as to available financing and capital restructuring alternatives, including recommendations of specific courses of action;
 - c. Assist the Company with the development, negotiation and implementation of a Restructuring, including participation as an advisor to the Company in negotiations with creditors and other parties involved in a restructuring;
 - d. Assist the Company with the design of any debt and equity securities or other consideration to be issued in connection with a Plan;

Ms. Chris A. Davis
McLeodUSA, Inc.
As of: October 25, 2001

Page 2 of 9

- e. Provide the Company and its Board of Directors with a fairness opinion, with respect to a Restructuring;
 - f. Assist the Company in communications and negotiations with its constituents, including, creditors, employees, vendors, shareholders and other parties-in-interest in connection with any Plan;
 - g. Render such other financial advisory and investment banking services as may be mutually agreed upon by Houlihan Lokey and the Company; and
 - h. Advise the Company with respect to proceeds received or tactics related to any sales of businesses.
2. Compensation. In consideration of our services pursuant to this Agreement, Houlihan Lokey shall be entitled to receive, and the Company shall pay to Houlihan Lokey, the following compensation:
- a. *Monthly Fee*: Houlihan Lokey shall be paid a monthly fee (the "Monthly Fee") each month in advance for its services of \$200,000 per month, plus reasonable Expenses ("Expenses" as defined herein) that are incurred by Houlihan Lokey on behalf of the Company, as of the date hereof. The Company shall pay the Monthly Fee by the 19th of each month, in advance. Payment shall be made to Houlihan Lokey according to wire instructions on each invoice, Attention: Jonathan B. Cleveland (see initial invoice attached hereto for wire instructions).
 - b. *Restructuring Transaction Fee*: In conjunction with a Restructuring Transaction the Company shall pay a cash fee (the "Restructuring Transaction Fee") equal to fifty one hundredths of a percent (0.50%) of the principal amount and all accrued interest or accreted principal of the Company Bond Obligations (defined herein) restructured, modified, amended, compromised or forgiven; such fee will be payable on the earlier of (i) the date of closing of such Restructuring Transaction or (ii) the date on which any amendment to or other changes in the instruments or terms pursuant to which any Company Bond Obligations were issued or entered into become effective. The Restructuring Transaction Fee shall be reduced by the amount of the Monthly Fees paid to and received by Houlihan Lokey beginning with the fourth Monthly Fee paid to and received by Houlihan Lokey and each Monthly Fee paid to and received by Houlihan Lokey thereafter. All fees due and payable in accordance with this subparagraph shall be in addition to any other fees payable under this Agreement.
 - c. *Other Services and Fees*: To the extent the Company requests Houlihan Lokey to perform additional services not otherwise identified herein, then the Company and Houlihan Lokey shall enter into a written agreement concerning Houlihan Lokey's services and fees for such services, which fees shall be on a mutually acceptable basis.
 - d. *Expenses*: In addition to the fees described above, the Company agrees to promptly reimburse Houlihan Lokey on a monthly basis for all documented out-of-pocket expenses reasonably incurred by Houlihan Lokey before termination (or related to Houlihan Lokey's pre-termination services) in connection with the matters contemplated by this Agreement, including reasonable fees of counsel (provided that such attorney fees will not exceed \$10,000 without the Company's consent). Out-of-pocket expenses shall include, but not be limited to, all documented and reasonable travel expenses, duplicating charges, computer charges, messenger services and long-distance telephone calls incurred by Houlihan Lokey.

10/25/01 18:13 FAX 318 298 7008

McLEODUSA EXECUTIVE
HOULIHAN LOKEY HOWARD ZUKIN

6123714479 P.24

Ms. Chris A. Davis
McLeodUSA, Inc.
As of: October 25, 2001

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e. **Tail Period:** Houlihan Lokey shall be entitled to the fees enumerated in any preceding subparagraph of this paragraph upon the earlier of (i) the occurrence, during the term, or within nine months after the date of termination by the Company, of this Agreement (such nine-month period being referred to herein as the "Tail Period"), of a Restructuring Transaction which incorporates a structure proposed, materially discussed with, or designed by Houlihan Lokey or (ii) the occurrence of any event specified in any such subparagraph with respect to which an agreement to consummate the same was agreed to in principle to or executed by the Company during the term or within the Tail Period.

The Company and Houlihan Lokey acknowledge and agree that the hours worked, the results achieved and the ultimate benefit to the Company, of the work performed, in each case, in connection with this engagement, may vary, and that the Company and Houlihan Lokey have taken this into account in setting the fees hereunder.

3. **Execution.** If the terms hereof correctly set forth our understanding and agreement, please so indicate by signing and returning the enclosed copy of this Agreement, immediately sending by wire transfer the initial Monthly Fee of \$200,000, and signing and retaining a duplicate for your records.

This Agreement shall be effective as of October 19, 2001 (the "Effective Date").

Very truly yours,

HOULIHAN LOKEY HOWARD & ZUKIN CAPITAL

By:


Jeffrey L. Orbalowski
Senior Managing Director

The foregoing Agreement (including the attached Standard Terms of Engagement) have been read, understood, accepted and approved, and the undersigned does hereby agree to retain Houlihan Lokey Howard & Zukin Capital upon the terms and provisions contained herein.

MCLEODUSA, INC.

By:



Name: Chris A. Davis

Title: Chief Operating and Financial Officer

Ms. Chris A. Davis
McLeodUSA, Inc.
As of: October 25, 2001

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STANDARD TERMS OF ENGAGEMENT
McLeodUSA, Inc.

1. Restructuring Transaction. As used herein the term "Restructuring Transaction" shall mean, (whether out-of-court or through a court approved transaction under Title 11 of the United States Code (the "Bankruptcy Code")) collectively, (a) any modification which effects amendments to, or other changes in, the instruments or terms pursuant to which any of the Company Bond Obligations were issued or entered into, the effect of which is to reduce the outstanding principal balance of such Company Bond Obligations or the issuer's cash debt service requirement in respect of such Company Bond Obligations or any other material modification that allows the Company to restructure (either in-court or out-of-court) on a stand-alone basis whereby a majority of the Company's common equity (on a fully diluted basis) is owned by existing creditors and/or shareholders; (b) any merger, consolidation, reorganization, recapitalization, business combination or other transaction pursuant to which the Company is acquired by, or combined with, any person, group of persons, partnership, corporation or other entity (including, without limitation, existing creditors, employees, affiliates, and/or shareholders) (collectively, an "Investor") where any Company Bond Obligations are impaired, compromised, forgiven or not assumed; (c) the acquisition, directly or indirectly by an Investor (or by one or more persons acting together with an Investor pursuant to a written agreement or otherwise), in a single transaction or a series of transactions, of (i) all of, or any material assets or operations of, the Company or (ii) any outstanding or newly-issued shares of the Company's capital stock (or any securities convertible into, or options, warrants or other rights to acquire such capital stock) (such capital stock and such other securities, options, warrants and other rights being collectively referred to as "Company Securities") resulting in holders of shares of the Company's capital stock immediately prior thereto owning less than 50% of such capital stock immediately thereafter where any Company Bond Obligations are impaired, compromised, forgiven or not assumed; (d) any transaction in which the requisite consent to a reorganization or restructuring are obtained either out-of-court or pursuant to a plan under the Bankruptcy Code (a "Plan"); or (e) any other going concern exit from a proceeding under Chapter 11 of the Bankruptcy Code.

Company Bond Obligations. As used herein the term "Company Bond Obligations" shall mean the principal amount plus any accrued and unpaid interest or accreted principal of any and all of the Company's funded bond debt obligations outstanding immediately prior to consummation of a Restructuring Transaction.

2. Advice. Except as may be required by law or court process, any opinions or advice (whether written or oral) rendered by Houlihan Lokey pursuant to this Agreement are intended solely for the benefit and use of the Company, and may not be publicly disclosed in any manner or made available to third parties (other than the Company's management, directors, advisors, accountants and attorneys) without the prior written consent of Houlihan Lokey, which consent shall not be unreasonably withheld.
3. Credit. Houlihan Lokey is hereby authorized, upon the consummation of a publicly-disclosed Restructuring Transaction, at its own expense to place a customary "tombstone" advertisement or similar announcement in such form and in such media as Houlihan Lokey deems appropriate. Any such advertisement will be placed only after review and approval of the Company, which shall not be unreasonably withheld.

Ms. Chris A. Davis
McLeodUSA, Inc.
As of: October 25, 2001

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4. Bankruptcy Court. In the event the Company files for relief under Chapter 11 of the United States Bankruptcy Code, the Company shall seek an order authorizing the employment of Houlihan Lokey, under the terms of this Agreement, as a professional person pursuant to (and subject to the standard of review of) Section 328(a) of the Bankruptcy Code. The Company shall submit Houlihan Lokey's employment application on the first day of any Chapter 11 filing and use its best efforts to cause such application to be considered on the most expedited basis. The order authorizing the employment of Houlihan Lokey as a professional person must be acceptable to Houlihan Lokey in its sole discretion. The terms of this Section are for the benefit of Houlihan Lokey only, and may be waived, in whole or in part, only by Houlihan Lokey.
5. Termination. The Company may terminate this Agreement upon 30 days written notice at any time and Houlihan Lokey may terminate this Agreement at any time upon 30 days written notice, in either case, without liability or continuing obligation; provided, however, that no expiration or termination of this Agreement shall affect (a) the Company's indemnification, reimbursement, contribution and other obligations as set forth in this Agreement, (b) the confidentiality provisions set forth herein and (c) if terminated by the Company, Houlihan Lokey's right to receive, and the Company's obligation to pay, any and all fees and expenses due, including, without limitation, any fees payable under Paragraph 2(e) hereof, whether or not any Restructuring Transaction shall be consummated prior to or subsequent to the effective date of termination, all as more fully set forth in this Agreement. If Houlihan Lokey terminates this Agreement, then it would not be entitled to any fees outlined under Paragraph 2(b) of this Agreement. Houlihan Lokey would be entitled to keep any Monthly Fees paid prior to termination.
6. Choice of Law. **THIS AGREEMENT SHALL BE GOVERNED BY THE LAWS OF THE STATE OF NEW YORK WITHOUT REGARD TO SUCH STATE'S RULES CONCERNING CONFLICTS OF LAWS. EACH OF HOULIHAN LOKEY AND THE COMPANY (ON ITS OWN BEHALF AND, TO THE EXTENT PERMITTED BY APPLICABLE LAW, ON BEHALF OF ITS EQUITY HOLDERS) WAIVES ANY RIGHT TO TRIAL BY JURY IN ANY ACTION, PROCEEDING OR COUNTERCLAIM (WHETHER BASED UPON CONTRACT, TORT OR OTHERWISE) RELATED TO OR ARISING OUT OF THE ENGAGEMENT OF HOULIHAN LOKEY PURSUANT TO, OR THE PERFORMANCE BY HOULIHAN LOKEY OF THE SERVICES CONTEMPLATED BY, THIS AGREEMENT.**
7. Other Services. If after termination of this Agreement, Houlihan Lokey is later called upon to render services directly or indirectly relating to the subject matter of this Agreement (including, but not limited to, producing documents, answering interrogatories, giving depositions, giving expert or other testimony, and whether by subpoena, court process or order, or otherwise), then the Company shall pay Houlihan Lokey's reasonable out-of-pocket costs and expenses, and the reasonable legal fees and expenses of Houlihan Lokey's legal counsel incurred in connection therewith; provided that this does not apply to and no additional fees shall be payable to Houlihan Lokey for work or activity related to efforts to seek confirmation of a plan of reorganization, and further provided that there shall be no reimbursement for legal fees and expenses of counsel retained by Houlihan Lokey unless Houlihan Lokey first requested that Company counsel perform such services and the Company or its counsel declined.

Ms. Chris A. Davis
McLeodUSA, Inc.
As of: October 25, 2001

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13. **Confidentiality.** Unless and until the Company publicly discloses the existence of this engagement, Houlihan Lokey shall treat the existence of this engagement as confidential, except to the extent the Company authorizes disclosure of such fact to any particular party. Houlihan Lokey acknowledges that, in connection with the services to be provided pursuant to this Agreement, certain confidential, non-public and proprietary information concerning the Company ("Confidential Information") has been or may be disclosed to Houlihan Lokey or its employees, attorneys and advisors (collectively, "Representatives"). Houlihan Lokey agrees that no Confidential Information will be disclosed, in whole or in part, to any other person (other than to any potential party to a Restructuring Transaction under appropriate assurances of confidentiality, to those Representatives who need access to any Confidential Information for purposes of performing the services to be provided hereunder, or as may be required by legal process), without the Company's prior consent. The term "Confidential Information" does not include any information: (a) that was already in Houlihan Lokey's possession, or that was available to Houlihan Lokey on a non-confidential basis, prior to the time of disclosure by the Company to Houlihan Lokey; (b) obtained by Houlihan Lokey from a third person which, insofar as is known to Houlihan Lokey, is not subject to any prohibition against disclosure; or (c) which is or becomes generally available to the public through no fault of Houlihan Lokey or any of its Representatives. Upon request, Houlihan Lokey agrees to return to the Company any Confidential Information, except for Confidential Information (i) incorporated into analyses, studies or other documents prepared by Houlihan Lokey or its Representatives, which Confidential Information shall continue to be held subject to the terms hereof, and (ii) which Houlihan Lokey is required to retain under any records retention policy or any law, regulation or securities exchange rule. If Houlihan Lokey becomes legally required to disclose any Confidential Information, prompt advance notice thereof shall be given to the Company, and Houlihan Lokey agrees to cooperate with any Company attempts to prevent such disclosure. In the event disclosure is required, Houlihan Lokey will provide only such information as is legally required.
14. **Successors.** This Agreement shall be binding upon the parties hereto and their respective successors and permitted assigns. Nothing in this Agreement, express or implied, however, is intended to confer or does confer on any person or entity, other than the parties hereto and their respective successors and permitted assigns and, to the extent expressly set forth herein, the Indemnified Parties, any rights or remedies under or by reason of this Agreement or as a result of the services to be rendered by Houlihan Lokey hereunder.
15. **Miscellaneous.** If it is found in a final judgment by a court of competent jurisdiction (not subject to further appeal) that any term or provision hereof is invalid or unenforceable, (i) the remaining terms and provisions hereof shall be unimpaired and shall remain in full force and effect and (ii) the invalid or unenforceable provision or term shall be replaced by a term or provision that is valid and enforceable and that comes closest to expressing the intention of such invalid or unenforceable term or provision. This Agreement embodies the entire agreement and understanding of the parties hereto and supersedes any and all prior agreements, arrangements and understanding relating to the matters provided for herein. No alteration, waiver, amendment, change or supplement hereto shall be binding or effective unless the same is set forth in writing signed by a duly authorized representative of each party.

The parties understand that Houlihan Lokey is being engaged hereunder to provide the services described above solely to the Company, and that Houlihan Lokey is not acting as an agent or fiduciary of, and shall have no duty of loyalty to, the equity holders or creditors of the Company or any other third parties in connection with this engagement. The Company agrees that it will be solely responsible for ensuring that any Restructuring Transaction complies with applicable law.

Ms. Chris A. Davis
McLeodUSA, Inc.
As of: October 25, 2001

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16. Indemnification. As a material part of the consideration for the agreement of Houlihan Lokey to furnish its services under the Agreement, the Company agrees to indemnify and hold harmless Houlihan Lokey and its affiliates, and their respective past, present and future directors, officers, shareholders, employees, agents and controlling persons within the meaning of either Section 15 of the Securities Act of 1933, as amended, or Section 20 of the Securities Exchange Act of 1934, as amended (collectively, the "Indemnified Parties"), to the fullest extent lawful, from and against any and all losses, claims, damages or liabilities (or actions in respect thereof), joint or several, arising out of or related to the Agreement, any actions taken or omitted to be taken by an Indemnified Party (including acts or omissions constituting ordinary negligence) in connection with the Agreement, or any Restructuring Transaction or proposed Restructuring Transaction contemplated thereby. In addition, the Company agrees to reimburse the Indemnified Parties for any legal or other expenses reasonably incurred by them in respect thereof at the time such expenses are incurred; provided, however, the Company shall not be liable under the foregoing indemnity and reimbursement agreement for any loss, claim, damage or liability which is finally judicially determined to have resulted primarily from the willful misconduct or gross negligence of any Indemnified Party.

If for any reason the foregoing indemnification is unavailable to any Indemnified Party or insufficient to hold it harmless, the Company shall contribute to the amount paid or payable by the Indemnified Party as a result of such losses, claims, damages, liabilities or expenses in such proportion as is appropriate to reflect the relative benefits received (or anticipated to be received) by the Company, on the one hand, and Houlihan Lokey, on the other hand, in connection with the actual or potential Restructuring Transaction and the services rendered by Houlihan Lokey. If, however, the allocation provided by the immediately preceding sentence is not permitted by applicable law or otherwise, then the Company shall contribute to such amount paid or payable by any Indemnified Party in such proportion as is appropriate to reflect not only such relative benefits, but also the relative fault of the Company, on the one hand, and Houlihan Lokey, on the other hand, in connection therewith, as well as any other relevant equitable considerations. Notwithstanding the foregoing, the aggregate contribution of all Indemnified Parties to any such losses, claims, damages, liabilities and expenses shall not exceed the amount of fees actually received by Houlihan Lokey pursuant to the Agreement.

The Company shall not effect any settlement or release from liability in connection with any matter for which an Indemnified Party would be entitled to indemnification from the Company, unless such settlement or release contains a release of the Indemnified Parties reasonably satisfactory in form and substance to Houlihan Lokey. The Company shall not be required to indemnify any Indemnified Party for any amount paid or payable by such party in the settlement or compromise of any claim or action without the Company's prior written consent.

Prior to entering into any agreement or arrangement with respect to, or effecting, any (i) merger, statutory exchange or other business combination or proposed sale, exchange, dividend or other distribution or liquidation of all or a significant proportion of its assets, or (ii) significant recapitalization or reclassification of its outstanding securities that does not directly or indirectly provide for the assumption of the obligations of the Company set forth in this Agreement, the Company will notify Houlihan Lokey in writing thereof (if not previously so notified) and, if requested by Houlihan Lokey, shall arrange in connection therewith alternative means of providing for the obligations of the Company set forth herein, including the assumption of such obligations by another party, insurance, surety bonds or the creation of an escrow, in each case in an amount and upon terms and conditions reasonably satisfactory to Houlihan Lokey.

The Company further agrees that neither Houlihan Lokey nor any other Indemnified Party shall have any liability, regardless of the legal theory advanced, to the Company or any other person or entity (including the Company's equity holders and creditors) related to or arising out of Houlihan Lokey's

McLeodUSA Incorporated and subsidiaries

Pre-Petition Secured Lenders

ABN Amro Bank
Bank of America
Bank of Nova Scotia
Citibank
Credit Suisse First Boston
Cypress Tree Investment Partners
Firststar Bank
Fleet National Bank
GSC Partners
Goldman Sachs
Harris Trust & Savings Bank
Heller Financial, Inc.
Salomon Smith Barney
Sankaty High Yield Partners
Toronto Dominion
Van Kampen

Additional Shareholders

Merrill Lynch Inv. Managers
Deloitte & Touche LLP
Cravath, Swaine & Moore (JP Morgan)
Arthur Andersen

Benefit Providers (Insurance)

Major Bondholders

Aegon
Appaloosa Management
Bank of America
Bennett Management
Blackrock
Citadel Investment Group
Conseco
Cypress Tree Management
Durham Asset Management
Federated
Fidelity

Franklin
Gruss & Company
Harvest Management
Lehman Brothers
Massachusetts Mutual
Merrill Lynch
Morgan Stanley
Oaktree
PIMCO
Prudential
Putnam
Royal Bank of Canada
Scudder
SunAmerica Investments

Major Vendors/Suppliers

Ameritech
AT&T
Global Crossing
Sprint
Time Warner
Ameritech Resellers Services
Ameritech-CABS
Ameritech-LEC Services
Lucent Technologies

Real Property Lessors

Coldwell Banker/The Wind Insurance Agency
Coldwell Banker
College 11555, LLP, c/o CB Richard Ellis
Sacred Heart Hospital
CB Richard Ellis, Inc.
Grubb & Ellis
CB Richard Ellis
CB Richard Ellis, Reichle Klein
Coldwell Banker Commercial
Coldwell Banker/Devonshire Realty
Grubb & Ellis Management Services, Inc.
Grubb & Ellis Management Services, Inc.
Prudential Insurance Co.
Public Storage
Warner Brothers, Inc.

EXHIBIT E

Professional Biographies

Jeffrey Werbalowsky

Mr. Werbalowsky is a Senior Managing Director and member of the Board of Directors of Houlihan Lokey Howard & Zukin. Mr. Werbalowsky has lead many of the firms largest merger and acquisition and restructuring engagements in his position as co-founder and national co-director of the financial restructuring group since 1988.

Mr. Werbalowsky earned a B.A. in Economics, magna cum laude, from the University of Virginia and a J.D. with honors from Columbia University, where he was a Stone Scholar for three years and an editor of the Columbia Law Review. Prior to joining Houlihan Lokey, Mr. Werbalowsky was chief executive officer of Cheviot Capital Corporation, an investment firm engaged in transactions involving bankruptcy and distressed situations. Prior to that, he was a member of Levene and Eisenberg, and prior thereto, an associate with Gibson, Dunn & Crutcher, where he practiced law and specialized in cases involving bankruptcy, corporate reorganization, and insolvency.

Mr. Werbalowsky has written a number of articles including; "Reforming Chapter 11: Building an International Restructuring Model," "Allocating Value In Canadian and American Restructuring Transactions," "Advising the Distressed Company," "Evaluating Distressed Securities," "Buying and Selling the Distressed Company," and "Deleveraging the Troubled Company," and has testified as an expert witness on a variety of restructuring and distressed security issues.

Jonathan B. Cleveland

Jonathan Cleveland is a Director in the Minneapolis office of Houlihan Lokey Howard & Zukin. Mr. Cleveland has been involved in a number of financial restructuring engagements with Houlihan Lokey, representing debtors and creditors in out-of-court restructurings and bankruptcies. Prior to re-joining Houlihan Lokey in 1997, Mr. Cleveland was an associate in the law firm of Mayer, Brown & Platt in Chicago, where he practiced corporate and securities law and was involved in numerous public securities offerings, public tender offers and private repurchase offers for debt and equity securities, and domestic and international acquisition transactions. Mr. Cleveland was a member of Houlihan Lokey's Financial Restructuring Group from 1990 to 1992, before earning a J.D. degree, magna cum laude, from the University of Minnesota Law School, where he also was a member of the Order of the Coif. In 1993, Mr. Cleveland studied international law at Uppsala University in Uppsala, Sweden. In 1990, Mr. Cleveland received a B.S. degree in Finance/Business Economics from the University of Southern California. Mr. Cleveland recently has served a senior role as the financial advisor to the following companies: Stage Stores, Metal Management, Purina Mills, and McLeodUSA, Incorporated; and a senior role as the financial advisor to the following bondholder/creditor committees: Loewen (now Alderwoods Group), Contifinancial, Levitz Furniture, and Heilig-Meyers Furniture.

Stephen Spencer

Stephen J. Spencer is a Senior Associate in the Minneapolis office. Prior to joining Houlihan Lokey Howard & Zukin Mr. Spencer spent three years as an investment banker in the Middle Market Mergers and Acquisition group at U.S. Bancorp Piper Jaffray. Before that Mr. Spencer spent four years at G.E. Capital where he executed a number of transactions in various G.E. Capital divisions including the National Restructuring Group, the Capital Markets Group, and in Structured Finance. Mr. Spencer has degrees in Biochemistry and Literature from the University of Wisconsin in Madison, and an MBA in finance from Fordham University in New York where he also taught as a graduate assistant in Economics Department. Mr. Spencer recently advised McLeodUSA in its financial restructuring transaction.

Fredrick F. Vescio

Mr. Vescio is a financial analyst at Houlihan Lokey's Minneapolis office. He is a recent graduate of the University of Michigan Business School with a degree in finance and accounting. Mr. Vescio is currently advising creditors committees in a number of large North American restructuring engagements in the industries of transportation, agricultural commodities, chemicals, telecommunications, and industrial goods.

EXHIBIT F

Summary of Fees and Expenses Payable

Restructuring Transaction Fee Calculation	
Principal and Accrued Interest or Accreted Amount on Notes as of January 31, 2002 ⁽¹⁾	\$ 3,042,843,253.00
Restructuring Transaction Fee ⁽²⁾	0.50%
\$ Amount of Restructuring Transaction Fee	15,214,216.27
Reduction for Monthly Fees Paid to and Received by Houlihan Lokey Beginning with the Fourth Monthly Fee	600,000.00
Agreed Upon One Time Reduction of Fee ⁽³⁾	500,000.00
Total Transaction Fee Due and Payable to Houlihan Lokey upon Confirmation of the Plan of Restructuring	\$ 14,114,216.27

Notes

(1) As set forth in the McLeodUSA Incorporated Disclosure Statement

(2) As agreed upon in section 2-b of the Retention Agreement between Houlihan Lokey and McLeod USA dated October 25, 2001

(3) As agreed upon between Houlihan Lokey and McLeod USA, and further codified in the revised application submitted to the US Bankruptcy Court on (insert date)

McLeod Expenses Feb - April 2002

1/16/02	jjw12/01	Telephone	\$88.03
1/22/02	Sprint	Telephone	\$489.38
1/28/02	Sprint	Telephone	\$50.00
2/22/02	Spring	Telephone	\$232.25
2/28/02	AT&T	Telephone	\$50.00
2/28/02	Sprint	Telephone	\$50.00
3/22/02	AT&T Wireless	Telephone	\$21.32
3/28/02	Sprint	Telephone	\$25.00
4/5/02	Sprint	Telephone	\$61.03
		Total	\$959.66

12/6/01	sjs12/01	Working Dinner	\$15.52
12/9/01	sjs12/01	Working Dinner	\$17.28
12/17/01	ffv12/01	Working Dinner	\$12.50
12/19/01	sjs12/01	Working Dinner	\$11.84
12/20/01	sjs12/01	Travel Meal	\$282.58
12/21/01	ffv12/01	Travel Meal	\$5.94
12/21/01	sjs12/01	Travel Meal	\$6.72
1/24/02	Creative Corp	Working Lunch	\$28.01
1/28/02	Ping's	Working Lunch	\$24.57
2/18/02	pettycash	Working Lunch	\$8.47
3/27/02	Waiters	Working Lunch	\$30.14
		Total	\$413.43

2/4/02	4-031-92288	Fed-Ex	\$52.79
2/4/02	4-079-84640	Fed-Ex	\$26.75
2/6/02	4-030-29304	Fed-Ex	\$16.44
2/6/02	4-030-96043	Fed-Ex	\$13.72
2/6/02	4-078-86131	Fed-Ex	\$27.39
2/19/02	4-126-53639	Fed-Ex	\$47.60
3/18/02	4-127-97755	Fed-Ex	\$30.06
		Total	\$214.75

12/14/01	ffv12/01	Taxi	\$15.00
12/20/01	sjs12/01	Car Rental	\$140.69
1/9/02	jjw2/02	Taxi	\$88.20
2/6/02	Carey	Carey Car	\$124.75
4/4/02	Carey	Carey Car	\$132.72
4/5/02	jbc	parking	\$34.00
		Total	\$535.36

12/12/01	ffv12/01	Airfare	\$690.19
12/13/01	billed 1/23/02	Airfare Credit	-\$3,041.00
12/14/01	ffv12/01	Airfare	\$379.75
12/14/01	sjs12/01	Airfare	\$379.75
12/14/01	sjs12/01	Airfare	\$690.19

12/20/01 ffv12/01	Airfare	\$690.19
12/20/01 sjs12/01	Airfare	\$690.19
1/10/02 JIW	Airfare	\$813.00
1/10/02 JIW	Airfare	\$475.00
4/4/02 jbc4/02	Airfare	\$1,282.00
	Total	\$3,049.26

2/28/02 Dow Jones	research	\$25.00
	Total	\$25.00

12/20/01 ffv12/01	Lodging	\$100.80
12/20/01 sjs12/01	Lodging	\$100.80
4/5/02 jbc	Lodging	\$268.27
	Total	\$469.87

Total		\$5,667.33
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EXHIBIT G

Order

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE**

In re:)	Chapter 11
)	
McLEODUSA INCORPORATED,)	Case No. 02-10288 (EIK)
Debtor.)	
)	
)	(Jointly Administered)

**ORDER GRANTING FINAL APPLICATION OF
HOULIHAN LOKEY HOWARD & ZUKIN CAPITAL FOR INTERIM
ALLOWANCE OF COMPENSATION AND REIMBURSEMENT OF EXPENSES
FOR THE PERIOD FEBRUARY 1, 2002 THROUGH APRIL 15, 2002**

This matter coming before the Court on the Final Application for Compensation and Reimbursement of Expenses for the Period February 1, 2002 through April 15, 2002 (the "Application") filed by Houlihan, Lokey Howard & Zukin Capital ("Houlihan Lokey"), financial advisor to the above-captioned Debtor; the Court having reviewed the Application and all pleadings relating thereto; and the Court having determined that the legal and factual bases set forth in the Application establish just cause for the relief granted herein;

THE COURT HEREBY FINDS THAT:⁽¹⁾

- A. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334.
- B. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

⁽¹⁾ Capitalized terms not otherwise defined herein have the meanings ascribed to them in the Application.

C. The Application complies, as applicable, with the requirements of the Bankruptcy Code, the Bankruptcy Rules, the Local Rules for the Bankruptcy Court for the District of Delaware and the Orders of this Court.

D. Houlihan Lokey's requested interim compensation for services rendered in connection with its representation of the Debtor during the Application Period is reasonable and appropriate under sections 328 and 331 of the Bankruptcy Code.

E. Houlihan Lokey's expenses incurred during the Application Period for which it seeks reimbursement were actual and necessary expenses under sections 330(a) (1)(B) and 331 of the Bankruptcy Code.

NOW, THEREFORE, IT IS HEREBY ORDERED THAT:

1. The Application is GRANTED.
2. Houlihan Lokey's request for a final allowance of compensation of \$14,114,216.27 and reimbursement for expenses of \$5,667.53 for the Application Period is hereby approved.
3. The Debtors are hereby authorized and directed to pay Houlihan Lokey the foregoing approved fees and expenses.

Dated: _____, 2002

UNITED STATES BANKRUPTCY JUDGE

CERTIFICATE OF SERVICE

I, Eric M. Davis, hereby certify that on the 21st day of June, 2002, I caused the **Final Application for Allowance of Fees and Reimbursement of Expenses of Houlihan Lokey Howard & Zukin Capital as Financial Advisor to the Debtor for the Period February 1, 2002 Through April 15, 2002**, to be served on the parties on Exhibit A, attached hereto, by first-class mail unless otherwise indicated.



Eric M. Davis

EXHIBIT A

McLeodUSA Incorporated

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