

CABLE SYSTEM TRANSFERS

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TRANSFERS OF OWNERSHIP

Transfer proceedings typically begin when a cable operator delivers to franchising authorities Federal Communications Commission (“FCC”) Form 394 requesting transfer of the cable television franchise and system. FCC Form 394 will include various attachments that will provide information regarding the proposed transferee’s legal, technical and financial qualifications.

The rules governing a transfer review are found in federal law at 47 U.S.C. §§ 533(d) and 537 and FCC regulations at 47 C.F.R. § 76.502. Franchising authorities must also carefully consider applicable state law and relevant provisions of the local franchise. In Minnesota see also Minn. Stat. § 238.083 regarding state law procedural requirements. Particular attention should be paid to the local franchise as it may contain additional transfer obligations and deadlines and may trigger rights for the franchising authority in the event of a change of ownership.

Under federal law, a franchising authority has 120 days from the date of submission of the completed FCC Form 394 to complete its review. The franchising authority must notify the cable operator within thirty days of the filing of FCC Form 394 if it questions the accuracy of the Form 394 information. If the franchising authority fails to act upon such transfer request within 120 days, such request is deemed granted unless the franchising authority and the requesting party otherwise agree to an extension of time.

Local

In any transfer of ownership, one of the key documents which must be reviewed is the franchise itself. To the extent the procedure outlined within a local franchise conflicts with state or federal law, state or federal law will govern. However, it is often possible to read procedural requirements within a local franchise consistently with federal and state law requirements, thereby adding additional complexity to the process which must be followed when reviewing the qualifications of the proposed transferee.

In some cases, it is possible that consent of the franchising authority may not be required. Franchising authorities should carefully review the transfer or assignment language within their local document and determine the type of transaction which the buyer and seller contemplate. Pay particular attention to stock transactions where the entity operating the cable system may not legally change, yet control of the parent company will fundamentally change.

Another significant issue to address immediately during a transfer of ownership proceeding is a “right of first refusal” provision or right to purchase a system upon sale or transfer. Many franchises across the country contain such purchase provisions and may be exercised when a transfer takes place. The exact language used to describe the purchase price is crucial in determining whether the franchising authority must pay

the bona fide purchase price offered by the transferee. In some circumstances, franchise agreements allow a franchising authority to purchase the cable system at the time of transfer with no value attributed to the franchise itself. Under those circumstances, a franchising authority may be able to purchase the system at a reduced price from the seller. Typically, the timeframe for exercising a right of first refusal is 30 to 60 days after notification of a proposed transfer. It is, therefore, essential that the city immediately analyze this issue and determine how it wishes to proceed.

In certain circumstances, other provisions within the franchise document are triggered upon the sale or transfer of the system. In some cases, these provisions may deal with system upgrade or the purchase of additional access equipment. In other cases, grants are triggered for support of PEG access, equipment and/or facilities if the system is sold or transferred. Franchising authorities should carefully review each and every provision of the franchise to determine if a proposed sale or transfer will trigger additional requirements.

Finally, it is important to carefully review the entire franchise document to ensure the existing cable operator has fully complied with its terms and provisions. Approval of a sale or transfer to a new cable operator may result in the franchising authority waiving its right to enforce certain franchise provisions if not raised prior to transfer approval. In addition, unless otherwise specified in the franchise document or transfer approval documentation, the transferee likely steps into the franchise document with a "clean slate." That is, the franchising authority can no longer raise past performance issues of the previous cable operator against the transferee at the time of renewal. Therefore, it is crucial for franchising authorities to clarify any ambiguities or other disputes in the franchise documents at the time of transfer.

FCC Regulations

47 C.F.R. §76.502 generally parallels the statutory requirements identified in Section 617 of the Cable Act (47 U.S.C. 537). Some of the key provisions of Section 76.502 are as follows:

Cable operators seeking to assign or transfer a cable system must submit a copy of FCC Form 394 to the local franchising authority if franchising authority approval of the transfer is required by the terms of the franchise agreement.

- A franchising authority shall have 120 days from the date of submission of a completed Form 394, together with all exhibits and any additional information required by the terms of the franchise agreement or applicable state or local law, to act upon such transfer request.
- A franchising authority must notify the operator within 30 days of the filing of Form 394 if it questions the accuracy of the 394 information.

- If the franchising authority fails to act upon such transfer request within 120 days, such request shall be deemed granted unless the franchising authority and the requesting party otherwise agree to an extension of time.

Legal Qualifications

When reviewing a proposed transfer of control, franchising authorities should document the ownership structure of the proposed transferee. Is the transferee a corporation or partnership? Who are the principals? In addition, inquiries should be made into the following items:

- 1) Current cable franchises.
- 2) Criminal or civil proceedings involving the transferee.
- 3) Revocations, suspensions, non-renewals of any business license of the transferee.
- 4) Other cable systems sold by the transferee or any pending cable franchise applications.
- 5) Cable franchise violations.

Technical Qualifications

With respect to the technical qualifications of the transferee, it is essential to identify any changes it may seek in the operation of the cable system or the franchise document. Inquiries should be made into the following items:

- 1) ***Changes to the system.*** Is the transferee proposing, or will the transferee undertake, any changes in the system including, but not limited to, programming, PEG access support, equipment, institutional network services, customer service, reporting, etc.?
- 2) ***Changes in the operation of the system.*** Is the transferee proposing or will the transferee undertake any changes in the operation of the system, including, but not limited to, billing practices, personnel, technical oversight, call center consolidation, etc.?
- 3) ***Changes to the franchise.*** Is the transferee requesting or will the transferee request any changes to the franchise document? In other words, will the transferee be seeking relief from any obligations which may require capital contributions or other burdensome requirements contained within the franchise. Is the proposed transferee willing to accept all of the franchise obligations or will it seek to challenge the enforceability of certain obligations?

Financial Qualifications

A review of the financial qualifications of the proposed transferee is a critical element in the transfer review process. The financial capability of the transferee will impact directly on the quality of service and the ability of the transferee to live up to its commitments under the franchise. The franchising authority should be provided with the documentation necessary to enable it to evaluate the transferee's financial qualifications. At a minimum, the franchising authority should receive the following information:

- 1) Copy of a letter of intent and/or purchase agreement. These documents will assist the franchising authority in identifying the transferee and the content of the agreement to transfer the cable system.
- 2) Corporate or business information documents, such as articles of incorporation, partnership and limited partnership agreements as well as management agreements.
- 3) Financing documents, such as a bank loan agreement or commitment letter; for limited partnerships, a proposed prospectus or offering circular, terms, and conditions of a limited partnership agreement; for a publication corporation, registration statements S-1 and all other forms filed with the Securities and Exchange Commission.
- 4) Current and historical financial statements of the transferee, including growth and revenue projections, income statements, sources and uses of funds, anticipated capital expenditures, justifications, depreciation schedules, charges for services, expenditures, other system new-build commitments, cash flow analysis, balance sheets, and proposed penetration rate.

This financial information and other documentation will help the franchising authority assess the financial impact of the proposed transfer on the system and its subscribers. The following elements and assumptions are critical to the determination of whether the financial projections provided by the transferee are reasonable:

- 1) **Profitability.** There are several components to consider a) operating ratio, b) operating margin, c) operating expenses, and d) pre-tax profit margin.
- 2) **Market Factors.** Several factors should be addressed in the proforma financial statements, including basic service penetration, pay-to-basic penetration, revenue per subscriber and household density. These projections should be reviewed carefully against past performance in the market.
- 3) **Capital Expenditures.** There are many components to the category of capital expenditures, including plant distribution costs, pre-operating expense,

headend costs, converter costs, connection costs, building costs or leasehold improvements. The capital costs projected in the proforma financials for such categories should be scrutinized for the reasonableness of the assumptions compared to the general industry standards.

4) ***Debt-to-Equity Ratio.*** The debt-to-equity ratio is a significant measurement in the context of a transfer transaction. This measurement shows long term debt as a percentage of overall capitalization. A low or conservative debt-to-equity ratio suggests the capacity to borrow additional funds. A high debt-to-equity ratio suggests a highly leveraged entity vulnerable to slight shifts in revenue or costs.

5) ***Cash Flow-Debt Service.*** The proforma financials should include a cash flow or source of funds schedule indicating projected annual income or depreciation which in turn would indicate projected cash flow, i.e., net income plus depreciation. Each of the foregoing components should be examined and compared to industry standards to determine whether the projections demonstrate the proposed transfer and subsequent operation of the cable system is financially feasible.

Conditions for Transfer

(1) ***Approval*** - To the extent a franchising authority determines to approve a proposed transfer, careful consideration of the transfer resolution should be undertaken. Be particularly careful when utilizing a form resolution submitted as part of FCC Form 394. Often cable operators may include provisions within such a resolution which may result in a waiver of existing franchise violations resulting in a "clean slate" for the proposed transferee.

In other words, there may presently exist a latent franchise violation such as failure to pay the proper franchise fee to the franchising authority. If a transfer resolution is executed with language indicating that the transferee assumes the franchise free and clear, the franchising authority may be prevented from thereafter pursuing the collection of past due franchise fees. Other common conditions for approval may include an acceptance agreement, guaranty, performance bond/letter of credit/security fund, and a certificate of insurance. Settlement of existing franchise obligations is also a possibility as well as resolution of franchise violations.

(2) ***Denial of Transfer*** - If a franchising authority chooses to deny the proposed transfer of control it may be based on a variety of reasons:

- (a) The transferee may lack the necessary legal, technical or financial qualifications;
- (b) The transferee may not agree to comply with valid franchise obligations; or
- (c) The transferee may eliminate or reduce competition in the community in violation of 47 U.S.C. § 533.

Moreover, in the event there is an existing franchise violation which has not yet been cured, a franchising authority may seek resolution of such a matter as part of a transfer proceeding. See 1992 Cable Act legislative history.

KEY LEGAL DECISION

Charter v. Santa Cruz Decision

On September 20, 2002, a three judge panel of the Ninth Circuit Court of Appeals overturned the leading case regarding cable television transfers of ownership. Charter Communications, Inc. v. County of Santa Cruz, 304 F.3d 927 (9th Cir. 2002). The Ninth Circuit decision vacates the district court opinion, Charter Comms. Inc. v. County of Santa Cruz, 133 F.Supp.2d 1184, 1187-1200 (N.D. Cal. 2001), which had been widely cited by the entire cable industry for the proposition that transfer approval cannot be unreasonably conditioned by a franchising authority. The industry had also cited the district court decision for the proposition that a cable operator cannot be compelled to reimburse the costs and expenses associated with a transfer review (see www.lawmoss.com).

The Ninth Circuit panel focused on one key issue in reviewing the district court decision. **Was the County's denial of consent unreasonable?** The court held that "when reviewing disputes emerging from [a] franchise agreement, a court must determine whether the county could have deemed it reasonable to deny consent; this is a much more forgiving standard than whether the district court judge would have denied consent himself if he were acting as the County's agent."

The Ninth Circuit held that it was reviewing a discretionary decision of the County Board of Supervisors, a legislative body. The court noted that review of a transfer of control is a "legislative act" entitled to deferential treatment by the court. Thus, whether the County denied consent reasonably is a question "governed not by a preponderance of evidence standard, but rather a substantial evidence test." Under such a deferential standard, the "County's denial of consent should be upheld as long as there is substantial evidence for any one sufficient reason for denial."

The Ninth Circuit found that the ability of the cable operator to adequately service the franchise throughout its term is a legitimate concern. It was not unreasonable for the County to be concerned about Paul Allen's (the key individual behind Charter) true net worth and about the relationship of that wealth to the viability of the enterprise. The court also held that district court erred by failing to give deference to the County's articulated concern for keeping stable the subscriber rates in the future. It was not unreasonable for the County to be worried about the long-term viability of the Allen purchase and its effects on the County's responsibility to assure a stable cable franchise for its citizens.

The Court also held that "even if we thought the County had acted unreasonably, our view would be deferential not only because precedent so commands, but also because methods exist to promote self-correction in the future: citizens can vote out their local representatives and cable operators can refuse to enter into franchise agreements with notoriously difficult local franchising authorities."

Therefore, the Ninth Circuit held that "since the County's judgment was reasonable, it necessarily follows that its decision to deny the transfer on the basis of that judgment was supported by a legitimate governmental interest." Charter voluntarily entered into an agreement under which the County had to approve any transfer of the franchise and thus, to that extent, waived its right to claim that a denial of the transfer violated its First Amendment rights. The Ninth Circuit cited multiple decisions arguing that First Amendment rights may be waived upon clear and convincing evidence that the waiver is "knowing, voluntary and intelligent."

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