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October 12, 1994

**HAND-DELIVERED**

Mr. Donald H. Gips  
Deputy Chief  
Office of Plans and Policies  
Federal Communications Commission  
1919 M Street, N.W., Room 822  
Washington, D.C. 20554

Re: PP Docket 93-253 - Ex Parte Filing

Dear Mr. Gips:

On behalf of the Broadband PCS venture between AirTouch Communications ("ATC") and U S WEST, Inc. ("USW"), this letter is submitted as a follow-up to our meetings concerning suggested changes to the rules governing ownership of applicants eligible for the Entrepreneurs Blocks in Broadband PCS.<sup>1</sup> As we hoped to impart in our meetings, ATC and USW are interested in furthering the development of DE-controlled entrepreneurial enterprises as an integral part of the ATC/USW PCS strategies. As such, ATC/USW have been aggressively pursuing strategic partnerships with Designated Entities ("DE"s) interested in bidding on the C and F Broadband PCS blocks, primarily enterprises owned by members of minority groups and/or females. ATC/USW's interests have developed both as an equity investor and as a strategic partner for such enterprises.

The risks of participating in PCS are substantial. Significant upfront capital expenditures are needed before any revenue streams can be created; even the more optimistic business cases do not anticipate meaningful returns on investment until well beyond the first five years of the license term. PCS is a new and unproven commodity, with technology not yet developed,

<sup>1</sup> See Ex Parte Letter from Kathleen O. Abernathy to William F. Caton, PP Docket 93-253, dated September 30, 1994.

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and it will be necessary for PCS to establish a market presence in a highly competitive environment already served by several existing providers. Adding to the mix the lack of experience and capital that DE's suffer, and it is apparent that any investment in a DE-controlled entity will constitute a high risk.

In evaluating a typical investment opportunity, investors would necessarily evaluate such risks and impose stiff operating guidelines on the management control group designed to mitigate those risks on an ongoing basis, or at least allow the investor to identify and respond to circumstances when those risks might be heightened by the control group's actions. Indeed, in such start-up, high risk ventures, equity investors would expect that most critical business decisions would be reached by a consensus of the management and investor interests. FCC regulations governing licensees in the Entrepreneurs Blocks, and the Commission's discussion of those regulations, have to date suggested that the DE interests must retain both de jure and de facto control, citing to the InterMountain case<sup>2</sup> for the "standard" by which the de facto control of various DE enterprises will be judged.

Moreover, while sanctioning certain non-majority investor agreements with the DE-controlled licensee, the FCC has defined "passive investment" -- to which most strategic partners will be limited -- in very general terms. This generality has left substantial uncertainty in the investment community as to whether rights typically reserved to non-majority investors in such capital intensive ventures will make their interests non-passive and/or constitute the exercise of control, and thus the transfer of control away from, the DE-owned control group.

Compounding this problem, the FCC has determined that many forms of equity investment that are typical of such risk oriented ventures -- designed largely to reward investors for risk-taking by increasing their preferred returns on their capital investment should the venture be successful -- must be treated on a fully diluted basis in determining equity ownership percentages, thus effectively denying their use in structuring DE-controlled enterprises. For example, convertible preferred stock, warrants, and similar offerings (often used to allow investors to increase their interest if and when a company is taken public) will be treated on a fully diluted basis, thereby denying investors the ability to obtain returns from DE-controlled groups consistent with other opportunities with which

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<sup>2</sup> InterMountain Microwave, 24 Rad. Reg. (P & F) 983 (1963).

they are presented outside of the PCS industry. Finally, the Commission has distinguished between corporations and other forms of enterprise in a fashion that could dictate uneconomic organizational structures<sup>3</sup>, although substantively there should be no difference in the management structure that can, under state law governing such structures, be imposed on the venture.

Unfortunately, the Commission's rules as currently stated and interpreted have erected unnatural barriers which will limit DEs' access to capital, as well as limit their access to the advantages gained from strategic partners. To correct this problem, several changes should be made in the rules and in the Commission's stated intention in enforcing them. First, the Commission should make clear in the definition of "passive equity" (and, in more detail, in the order on reconsideration) that non-majority protections typical of such capital intensive investments will not constitute otherwise passive equity as non-passive, and will not constitute activities that would shift de facto control from the DE-owned control group to the non-DE investors. Specifically, the definition should be amended by adding a sentence so that it reads:

**Passive Equity.** *Passive Equity* shall mean (i) for corporations, non-voting stock or stock that includes no more than fifteen percent of the voting equity; and (ii) for partnerships, joint ventures and other non-corporate entities, limited partnership interests and similar interests that do not afford the power to exercise control of the entity; provided, however, that the reservation to the holder of passive equity of rights to vote on certain matters subject to super-majority voting requirement that relate to matters

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<sup>3</sup> For example, the Commission's definition of passive investment appears to allow an investor to hold actively participating voting interests in a corporation, but is not clear as to whether such investor may hold similar rights, for example, as a member of a management committee of a limited partnership that is, by the limited partnership agreement (and in accordance with the laws of the state of formation), established and delegated with many of the duties and powers that would typically be assigned to a corporation's board of directors.

beyond the day-to-day operation of the licensee's business shall not affect the characterization of the equity as passive.

The Commission should also make clear that fairly negotiated corporate or partnership organizational structures that reserve to unanimous or supermajority voting of all equity owners certain actions of the venture, will be acceptable rights that will not cause the investment to be deemed "active".<sup>4</sup> Such matters should include, for example,

1. approval of the initial and annual budgets and strategic business plans by which the business of the licensee will be generally operated, and/or any actions during the year that would result in substantial deviations from such business plan (thus assuring non-majority investors that the business is generally being managed in accordance with their reasonable commercial expectations);
2. capital expenditures above certain reasonable amounts, unless already approved in the budget or business plan (to assure that the business will not be expanded inefficiently or without adequate consideration on management's part of risk potentials);
3. borrowing in excess of a certain designated amount (to assure that the business is not unreasonably leveraged);
4. the termination and/or employment of key executive personnel (to assure that the strategic nature of the investment is not jeopardized by the replacement of key executive management; this could extend to granting non-majority investors the right to appoint certain officers (e.g., vice president-technical services) when such investors' representatives possess unique capabilities in these areas;

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<sup>4</sup> Both ATC and USW have extensive experience as participants in wireless ventures outside the U.S. Generally, in these ventures, there are significant government restrictions placed on the ownership levels of foreign participants, like ATC and USW, and on the ability of foreign participants to control the operation of the venture. Nonetheless, ATC and USW generally receive significant minority investor protections, including the right to participate in management committees, to approve the ventures' business plan and to appoint key executive officers (technical and marketing personnel).

5. entering new businesses and/or merging with or acquiring new businesses (to assure that the investment remains in PCS and not in, or as a part of, some unrelated venture);
6. the sale of substantially all of the assets and/or the liquidation of the business (to assure that they retain their ongoing interest in the PCS licenses even if the DE wants to exit from the business by an asset rather than ownership interest sale);
7. transactions with affiliates of the DE-owned control group (to avoid the transferring of disproportionate economic benefits through transfer pricing to affiliates);
8. issuance of capital calls on equity owners (to avoid dilution of ownership through unnecessary capital calls).

Moreover, other investment rights should be sanctioned by the Commission as typical of rights appropriately attached to such high risk investments without creating undue influence on the enterprise in a non-majority investor. In this regard, the rules should be amended to allow non-majority investors to enjoy the following rights:

1. Preferred convertible debt that is convertible at fair market rates sometime during the five year period following the end of the restrictions on transfers of the license<sup>5</sup>;
2. warrants attached to the passive equity that will allow the investor to increase its interest in the licensee contemporaneous with certain recapitalization events, i.e., public offerings, mergers, etc.
3. Rights of first refusal on the sale of any member of the DE-owned control group's interest in the control group or in the licensee, or on the sale by the control group of its interest in the licensee;

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<sup>5</sup> ATC/USW believes that all references in the rules to conversion rights, warrants, calls and other investor interests relate only to the ten-year license term, and would not extend to rights that may be reserved to the non-majority investor and exercisable only after the initial license term. To the extent, however, that there is some ambiguity in the rules, ATC/USW urges that this be clarified on reconsideration.

4. Call options by which the interest of the DE-owned control group may be called by the non-majority investor at fair market value, and if such call occurs during the first five years, then it can only be exercised by, or on behalf of, another DE-owned control group.

For the reasons discussed below, none of these vehicles should be considered as increasing the non-majority investor's equity ownership interest in, or otherwise affect its non-controlling participation in, the licensee venture.

Convertible preferred debt is a typical method of financing high risk start up ventures;<sup>6</sup> it allows a financier to provide capital on a debt basis that is convertible into an equity investment if and when the venture proves itself. Warrants are another typical means for a risk-taking investor to increase its ownership interest should the venture indeed become successful enough to obtain some of its appreciated value through various recapitalization means. Neither vehicle is considered a "hammer" over the operation of the business by its management/-founding owners (in this case the control group). Rather, these are instruments that incent the controlling party to do well with the capital invested, but also recognize that high rewards are due to the provider of high risk capital if the risks taken bear fruit in the form of a successful venture.

Rights of first refusal are critical for a non-majority equity investor as a means of assuring that it remains comfortable with the majority interest holder; in the absence of this right, the majority holder might sell all or part of its interest to a party with whom, for a variety of reasons, the non-majority

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<sup>6</sup> In confirming that convertible preferred debt can be used to finance a DE-controlled applicant, the FCC should also expressly confirm that commercially reasonable debt covenants can be negotiated by the non-majority investor who also finances the applicant and/or the DE-owned control group through secured financing. For example, banks typically require borrowers to meet and maintain specified financial ratios, restrict major asset sales, impose requirements to maintain certain key management and/or service and franchise contracts and otherwise provide restrictive covenants on the use of their security. The FCC should confirm its expectation that fairly negotiated debt from a strategic partner might contain similar conditions without affecting the de facto control held by the DE-control group.

player is unable or reasonably unwilling to do business. A right of first refusal allows the DE owner to sell its interest in the DE-owned control group or in the licensee for a fair price. But the sale will be to the non-majority investor or its designee, instead of to a third party.<sup>7</sup>

A call option (particularly one that is tailored to the FCC's restrictions on transferability) is an essential protection for an investor against the possibility of bad management. In the current environment, where the risks of PCS are substantial (particularly given the numerous concerns about product line, technology, infrastructure costs and competition that are inherent in a still-developing industry), it is difficult for any investor to be certain that the DE groups that it has chosen to support will be fully capable of fulfilling its anticipated objectives. So long as an investor is willing to continue its commitment to the PCS network, it must have a vehicle for rectifying serious problems with its choice of DE-controlled majority partner, and the type of call proposed provides that vehicle. It would be unfair to deny to the non-majority investors -- particularly in situations where they own a substantial majority of the equity -- such a reasonable vehicle for removing a non-performing DE, at fair market value, and replacing it with another DE-owned control group.<sup>8</sup>

Finally, while sanctioning the use of management agreements by the non-majority investor, the Commission has not

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<sup>7</sup> Because ATC/USW understands that the Commission is appropriately considering a rule change to allow institutional investors to own passive equity in the DE-control group, it is important to the strategic partner that this right of first refusal may, if negotiated, also extend to the sale by the DE-owners of their interests in the control group. This protects the strategic partner from sales of indirect ownership interests that could not be completed through the sale of the direct interest of the DE owners in the licensee.

<sup>8</sup> This is not a right to be exercised lightly. If the DE-owned control group is performing its management functions successfully, there will be no incentive by the non-majority investors to trigger the call to replace known management with unknown entities. On the other hand, if the management is not performing, investors need this protection as an alternative to simply "pulling the plug" on the venture, thereby affecting not only the DE and the investor, but also the licensee's provision of service to the public.

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established with equal clarity that other, similarly directed agreements between the DE-controlled licensee and its passive investors will also be allowed. To assure that there is no significance given to this silence, the Commission should make equally clear its approval of such agreements.

For example, many PCS licensees may desire to enter into licensing and franchising arrangements with their strategic partners to get the benefit of scale economies associated with necessary services, large scale purchasing power to meet capital and infrastructure requirements, and brand name marketing opportunities.<sup>9</sup> These agreements typically contain operating standards established by the franchisor/licensor designed to assure an effective national presence for the franchise. In order to avoid the costs and delays that are certain to occur during the PCS licensing process, the Commission must make clear in its rules and decisions that DE-controlled applicants may enter into such long-term franchise arrangements with non-majority strategic investors.

In closing, we note that the original and two copies of this filing were submitted to the Secretary of the FCC in accordance with Section 1.1206(a) (1) of the Commission's rules.

Please contact the undersigned at 202-293-4960 should you have any questions or require additional information concerning this matter.

Sincerely,

  
Kathleen Q. Abernathy

cc: William F. Caton, Acting Secretary - FCC  
Rosalind K. Allen  
Sara Seidman  
Andrew E. Sinwell  
Peter A. Tenhula

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<sup>9</sup> The Commission apparently now recognizes the benefit of inducing institutional investment in the DE-owned control group. In ATC/USW's experience, the existence of such licensing and service agreements significantly enhances the DEs' ability to obtain such institutional investor commitments.

## Summary of Points

- Investment in DE-controlled enterprises is a significant part of ATC/USW's Broadband PCS Strategy.
- Strategic Partner investment in DE-controlled applicants provides DE's with access to capital, expertise, and a larger PCS participation opportunity.
- Rules must be clarified to confirm that the reservation of certain non-majority investor protections and the participation of non-majority investors in decision-making on certain critical business issues will not result in those investors being deemed to hold "active" rather than "passive" equity.
- Included among such rights would be:
  - the right to hold preferred convertible debt;
  - warrants to increase the investor's interest in the licensee contemporaneous with certain recapitalization events, i.e., public offerings, mergers, etc.;
  - Rights of first refusal on the sale of any member of the DE-owned control group's interest in the control group or in the licensee, or on the sale by the control group of its interest in the licensee;
  - call options by which the interest of the DE-owned control group may be called by the non-majority investor at fair market value, and if such call occurs during the first five years, then it can only be exercised by, or on behalf of, another DE-owned control group.

Among the items on which investors should be able to vote in a meaningful fashion, (i.e., that should be subject to unanimous or supermajority voting approval) are:

- approval of the initial and annual budgets and strategic business plans by which the business of the licensee will be generally operated, and/or any actions during the year that would result in substantial deviations from such business plan;
- capital expenditures above certain reasonable amounts, unless already approved in the budget or business plan;
- borrowing in excess of a certain designated amount;

- the termination and/or employment of key executive personnel;
- entering new businesses and/or merging with or acquiring new businesses;
- the sale of substantially all of the assets and/or the liquidation of the business;
- transactions with affiliates of the DE-owned control group;
- issuance of capital calls on equity owners.