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EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *PP Docket No. 93-253, Designated Entity Issues*

On October 25, Gregg Skall of Pepper & Corazzini and I met with Jill Luckett of Commissioner Chong's office to discuss issues contained in the attached document which was used during the meeting. Please associate this material with the above-referenced proceeding.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Alan F. Ciamporcero

Attachment

cc: Jill Luckett

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Washington, D.C. 20554

Re: Ex-Parte Notice
PP Docket No. 93-253
Designated Entity Issues

Dear Mr. Caton:

On Tuesday, October 25, the undersigned, together with Alan Ciamporcero of Pacific Telesis Group, met with Jill Luckett of Commissioner Chong's Office to discuss various points regarding designated entity issues.

In particular, Pacific Telesis raises the following points for consideration in the hope that they will be addressed in the forthcoming Report and Order on reconsideration in this Docket. As Pacific Telesis and others implement investment strategies with designated entities, it is becoming increasingly clear that further guidance on various structural issues is necessary. The requested guidance falls in the following categories.

1. **Management and Service Agreements**.

Both designated entities with which Pacific Telesis has spoken and Pacific Telesis itself consider it desirable to allow the designated entity to contract with various units of an investing partner for services. The Commission itself recognized in the Fifth Report and Order that designated entities should be able to take advantage of experience and expertise which may reside with investing partners. Indeed, many experts believe that it will require experienced telecommunications operators to manage PCS enterprises. A standard practice in the telecommunications industry is to obtain that experience through management or service agreements. As designated entities are, by definition, start-up organizations generally inexperienced in operating large telecommunications ventures, resort to management and service agreements should be considered desirable and useful in the highly competitive business environment in which these entities will find themselves. Experienced investing parties may be able to provide services in such categories as network design, network construction and maintenance, development of the operational plan, pricing, marketing and sales, customer service, and billing and collection as well as others. The designated entity's ability to garner for itself such experience through management and service agreements is also of central importance to investment decisions by potential partners.

The Commission has indicated its intention to rely upon Intermountain Microwave[1/] for examining these agreements to determine whether a designated entity remains in de facto control of a licensee. However, application of the Intermountain Microwave criteria has become unclear because of the remand by the United States Court of Appeals for the District of Columbia of Telephone and Data Systems, Inc. v. FCC.[2/] Accordingly, it is important for the Commission to specify and restate a bright-line test of the factors it will consider in determining de facto transfer of control in connection with such agreements. Moreover, to the extent that the designated entity seeks to use the service marks and good will of an investing partner in its marketing efforts -- and many have indicated that such is their desire -- it becomes even more important that the investing partner and its shareholders be satisfied that the service provided to the public will be of the consistent high quality with which its brand names have become associated.

Therefore, designated entities and their partners should be free to enter into management contracts that promote the effectiveness of the venture and maintain a consistently high level of service. The designated entity should at a minimum be required to provide management level policy guidance and continuing on-location supervisory oversight. Industry partners under contract should be permitted to carry out essential operational functions in accordance with the designated entity's operational plan and the guidance and instructions of the designated entity with controls to assure that those functions are executed to the control group's satisfaction. The Commission should establish now a bright line test to determine a method by which the designated entity may be deemed to be properly fulfilling those policy and supervisory responsibilities in situations involving management and service agreements. The Commission should also

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1/ Intermountain Microwave, 24 Rad. Reg. 983, 984 (1983).

2/ Telephone Data Systems, Inc. v. FCC, 19 F3d 42 (D.C. Cir. 1994).

state that management contracts may provide for termination only for good cause.

In addition, the test for *de facto* transfer of control should be applied to each service agreement individually. Should multiple service agreements be entered into, each of which retains satisfactory control in the designated entity, parties should not be heard to complain that taken together the service agreements amount to more than the sum of their parts. If the Commission believes, however, that such an argument would be valid, it should provide a bright line to explain at what point the accumulation of functions, notwithstanding the retention of designated entity management responsibilities and supervisory authority, constitutes a *de facto* transfer of control.

2. The Commission Should Provide Advance Rulings on Structure and Management Agreement Issues.

As parties move forward to establish designated entity partnerships, the sheer magnitude of the investment requires that both sides achieve a degree of certainty in their relationship. Additional uncertainty regarding management and service contract limitations will limit opportunities for designated entities to structure alliances. It is in the best interest of all parties that the Commission entertain advance rulings on actual proposed agreements between parties. This method of advance guidance worked well to provide counsel to the public when the Commission began to entertain expanded Time Brokerage Agreements, sometimes referred to as a Local Marketing Agreement or "LMA". That early advice, given to a number of parties, served the needs of the whole radio broadcasting industry for a degree of certainty as this new mechanism for delivery of broadcasting services unfolded.

Now, before the short form applications are due for the designated entity reserved frequency blocks C and F, the Commission should entertain similar requests for advance rulings. Furthermore, should parties, in good faith, enter into management and service agreements between them which are ultimately determined to have exceeded the *Intermountain* tests or others the Commission may adopt, they should be provided a limited grace period within which to bring their contractual arrangements into compliance with the Commission's policies and rules.

3. **Allocation of Financial Attributes.**

In addition to those financial incentives for partnering with a designated entity already implemented by the Commission, there are additional incentives allowable under the Internal Revenue Code. Designated entities should be permitted to implement these devices without their raising inferences of sham transactions or de facto transfers of control. Such devices include:

(a) The allocation of tax attributes on a non-pro rata basis to equalize partner economics. For example, should the parties submit disproportionate capital contributions, the Internal Revenue Code at Section 704 allows for the allocation of operating losses. The ability to allocate tax benefits, such as early year operating losses or depreciation, provides additional flexibility in structuring beneficial to the parties.

Moreover, the designated entity will most likely not have sufficient income to gain the tax benefit currently, resulting in little or no impact upon their after-tax returns. As many designated entities will not have sufficient capital to fund equity and operating losses, loans will be required from the industry partner or financial investors. Accordingly, the designated entity may not have a sufficient tax basis to justify pro rata allocation of tax attributes. Section 704 of the Internal Revenue Code allows non-pro rata allocation. The Commission should recognize the economic good sense that is reflected in this section of the Revenue Code.

(b) Preferential rights to dividends should also be permitted to equalize disproportionate capital contributions for the same reasons which justify the allocation of tax attributes.

4. **Debt and Lease-Back Agreements.**

As an additional financing vehicle, the designated entity should be permitted to obtain its equipment by lease from any qualified party willing to purchase and lease the equipment specified by the designated entity. The investing partner should be allowed to be among those entities willing to provide this funding mechanism. Debt and lease-back agreements have long been recognized to be acceptable financing vehicles and are widely used in the telecommunications industries. They serve to provide initial capital funding for capital intensive businesses which are thereby provided a method to spread those expenditures over time with equal lease payments. The Commission has itself recognized that debt and lease-back agreements do not confer a cognizable interest in the holder and there is no direct influence or control which pertains to them. Further, any indirect influence or control, if it occurred, would be irregular to such vehicles. In connection with broadcasting, the Commission has said that inclusion of debt in the Commission's attribution rules would create numerous rule violations among existing licensees and present extremely severe restrictions on capital sources.[3/]

5. **<u>Rights of First Refusal.</u>**

While we appreciate that options are outside the letter and spirit of the Commission's designated entity rules and therefore are to be treated as fully diluted ownership interests, investing partners should be permitted to obtain rights of first refusal from their designated entity partners were they to announce an intention to sell or transfer their interest to third parties. A right of first refusal is universally recognized in the financial community as an appropriate safeguard mechanism for investors to retain the ability to assure the identity of those with whom they are in business. A right of first refusal does not carry the ability to call the stock upon any event other than a proposed sale to a third party. Since such a sale would in itself alienate the designated entity stock, the investing partner should then be permitted to obtain it upon like terms before it may be sold to third parties.

6. **<u>Loans From the Investing Partners To the Designated Entity or Its Principals.</u>**

As designated entities are expected to have comparatively less capital that would be required for pro rata contributions of start-up costs, the investing partner should be permitted to make loans to the designated entity, or to its principals for their capital contribution, upon normal and customarily acceptable commercial terms. Those terms should include the right to obtain stock pledge agreements from the designated entity principals and security agreements on the equipment of the enterprise. Such security mechanisms are generally permitted under an analysis of transfers of control in broadcast situations provided appropriate control mechanisms are included in the provisions of such security documents. Appropriate controls include, <u>inter alia</u>, an inability to transfer only with the prior consent of the Commission upon proper application. Given the flexibility to make such loans with appropriate security, designated entities and their

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3/ In the matter of <u>Re-examination of the Commission's Rules and Policies Regarding the Attribution of Ownership Interests in Broadcast, Cable Television and Newspaper Entities</u>, MM Docket No. 83-46, 55 RR 2d 1465, 1484 (1994).

partners will be provided with maximum flexibility for pro rata contributions of capital and other methods of allocating resources and financial benefits. Moreover, the fact that such loans are made under these conditions should not affect the determination that the designated entity maintains a substantial interest in the enterprise.

7. **Liquidation Preferences.**

If the company should incur financial reversals or for other reasons a liquidation or sale of the business is required, the capital contributors should receive returns of capital prior to pro rata distributions to shareholders. Allowing liquidation preferences is a commonly used method to equalize for disproportionate capital contributions and are generally required by the financial community.

8. **Clarification of Super Majority Voting Rights.**

Although control must reside in the designated entity, investing partners should be afforded the ability to secure their investment through the use of super majority voting rights in situations which could have major consequences to the enterprise. Examples of such situations where super majority voting rights may be considered appropriate include the following: A major change to the business plan that modifies the principles upon which the designated entity was founded; extraordinarily large and uncontemplated capital expenditures; changes to the Articles of Incorporation or Partnership Agreement governing the venture, substantial change in the debt/equity ratio maintained by the business; the admission of a new general partner; a major acquisition of a new business; diversification into other lines of business; and the selection or replacement of "key employee" officers.

Most of the foregoing represent super majority provisions commonly found in governance documents for entities involved in capital and service intensive industries. Permitting them allows the removal of a degree of uncertainty respecting matters which could have major impact upon the business as originally agreed to by the partners.

The items mentioned in this letter represent the major areas of concern which have been raised in designated entity discussions. A number of them have been proposed in the previous comments to the Commission by Pacific Telesis as well as parties who expect to be involved in designated entity control groups. Generally, they are useful and customary matters of commercial practice in the telecommunications industry and financial community. It is highly desirable that the Commission provide a new level of certainty and predictability for parties now engaged in designated entity formation discussions.

Respectfully submitted,

PACIFIC TELESIS

By: Gregg P. Skall /lc
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Its Attorney

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