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KIRKLAND & ELLIS
PARTNERSHIPS INCLUDING PROFESSIONAL CORPORATIONS

655 Fifteenth Street, N.W.
Washington, D.C. 20005

202 879-5000

Steven G. Bradbury
To Call Writer Directly:
(202) 879-5082
steven_bradbury@kirkland.com

Facsimile:
202 879-5200

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

January 4, 2000

BY HAND

Magalie R. Salas, Esq.
Secretary
Federal Communications Commission
The Portals
445 Twelfth Street, S.W.
12th Street Lobby, TW-A325
Washington, D.C. 20554

Re: *CC Docket No. 98-184; Ex Parte Filing*

Dear Ms. Salas:

Enclosed are two copies of a written *ex parte* to be filed on the public record in the above-referenced docket. By copy of this letter, I am hand delivering this document to the persons listed below.

If you have any questions, please contact me.

Very truly yours,

Steven G. Bradbury

Steven G. Bradbury

SGB:pd

cc (w/encl.): Dorothy Attwood, Esq.
Christopher Wright, Esq.
Lawrence Strickling, Esq.
Robert Atkinson, Esq.
Paula Silberthau, Esq.
Michelle Carey, Esq.

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January 4, 2000

The Creation of a Public Corporation With an Option Will Fully Resolve the Section 271 Issue for GTE/Bell Atlantic

In our meeting with staff on December 21, 1999, we described a proposal to transfer GTE Internetworking Incorporated to a public corporation of which the merged GTE Corporation/Bell Atlantic Corporation will own 10% with an option to increase ownership in the future. This paper explains why this proposal satisfies the legal requirements of section 271 and will allow the GTE/Bell Atlantic merger to close once the Commission has given its public interest approval.

Description of the Proposed Structure

GTE/Bell Atlantic will eliminate the section 271 issue caused by Bell Atlantic's acquisition of GTE Internetworking's data business through the following structure:

GTE Internetworking ("GTE-I") will be transferred into a new public corporation ("DataCo") that will be 90% owned and controlled by public shareholders. The merged GTE/Bell Atlantic ("NewCo") will hold a 10% voting and economic interest in DataCo with an option to increase its ownership to 80% within five years from the closing of the merger. (This percentage may be adjusted depending on the amount of capital raised in the IPO of the public shares.) If NewCo has failed to receive sufficient relief from the section 271 restrictions after five years, NewCo will either sell its stock and convertible interest in DataCo or exercise the option solely for the purpose of disposing of any DataCo assets that are prohibited to NewCo under section 271. Before exercise of the option, the public shareholders will have 90% of voting control and will receive 90% of any profits or other financial return derived from DataCo.

Until NewCo has received sufficient 271 relief to exercise its option, DataCo will be independent of NewCo. NewCo will not participate in its management, and the members of DataCo's board of directors will be periodically elected by the voting shareholders consistent with the requirements of applicable corporation laws. The directors and officers of DataCo will owe fiduciary duties to the public shareholders. Incentive compensation for DataCo's managers will be tied to the performance of DataCo and the value of DataCo's publicly traded stock, not to the financial performance or stock value of NewCo. The primary source of interim financing for DataCo will be the capital contribution from the IPO. Any additional funding required by DataCo during the interim would be raised from the public debt markets or by an arm's-length commercial loan from NewCo.

There will need to be certain commercial arrangements between NewCo and DataCo before the option is exercised. First, NewCo and DataCo will jointly market their services outside the Bell Atlantic region and in Bell Atlantic states as and where NewCo has attained relief under section 271. Since DataCo will now be a separate public corporation, all commercial interactions between NewCo and DataCo will be pursuant to commercially reasonable contracts. In addition, NewCo will have certain reasonable investor protections, such as covenants or charter and by-law provisions, that are typical of rights commonly held by option holders or other prospective acquirers and regularly permitted by the Commission. These protections will include the right to approve certain fundamental business changes that could be inconsistent with NewCo's minority investor and option rights, including a change in control of DataCo or the sale of a significant portion of its assets.

Discussion

I. Before Exercise of the Option, DataCo Will Not Be an "Affiliate" of NewCo for Section 271 Purposes.

Section 271(a) generally prohibits a Bell operating company, or "BOC," from providing interLATA telecommunications originating in an in-region state, whether directly or through an "affiliate," until the BOC has received authority to do so under section 271(b). 47 U.S.C. § 271(a). The controlling definition of "affiliate," set forth in section 3(1) of the Communications Act, 47 U.S.C. § 153(1), provides:

> The term "affiliate" means a person that (directly or indirectly) owns or controls, is owned or controlled by, or is under common ownership or control with, another person. For purposes of this paragraph, the term "own" means to own an equity interest (or the equivalent thereof) of more than 10 percent.

Under the proposed structure described above, NewCo will not own or control DataCo, and thus DataCo will not be an "affiliate" of NewCo's BOCs within the meaning of section 3(1).

A. NewCo Will Not "Own" DataCo.

Pending 271 relief, NewCo's equity interest (or the equivalent) in DataCo will not exceed the permissible 10% level, and thus NewCo will not "own" DataCo for purposes of the Communications Act. NewCo will only own 10% of the voting equity of DataCo. In addition, NewCo will be limited to a 10% economic interest. Thus, before the option is exercised, NewCo's equity interest will entitle it to receive no more than 10% of any profits or other interim economic benefit derived from DataCo. NewCo will not be able to take advantage of the tax benefits resulting from net operating losses incurred by DataCo during the interim and will receive no other current financial benefit from its limited stake in DataCo.

The fact that NewCo's shares will be convertible at NewCo's option into an 80% voting and economic position does not mean that NewCo will own a greater than 10% equity interest before the option is exercised. The Commission's own prior rulings, as well as other relevant legal precedents, all uniformly establish that such options or conversion rights do not constitute an attributable ownership interest unless and until they are exercised.

1. Commission Rulings

The Commission has consistently ruled in all relevant contexts that call options and other conditional interests, specifically including convertible securities, do not give the holder an attributable ownership interest. This conclusion holds whether or not the call or conversion rights are purchased for pre-established consideration and thereby allow the holder to realize a potential gain in value when the rights are exercised.

Thus, the Commission has permitted BOCs to purchase fixed-price options in firms engaging in lines of business prohibited to BOCs under the Modification of Final Judgment, or "MFJ," which was the direct legal antecedent to section 271. In *In re Tel-Optik Limited*, 1 FCC Rcd 742 (1986), *aff'd*, 2 FCC Rcd 2276 (1987), the Commission allowed NYNEX to acquire an option in a company that operated a prohibited interLATA business (trans-Atlantic cables from New York) where the option could be exercised for a price fixed by a pre-negotiated formula, regardless of the acquired company's value at the time the option was exercised. Accordingly, the option was not considered ownership even though the arrangement would allow NYNEX ultimately to realize any gain in the value of the acquired interest above the pre-established purchase price. Moreover, the express purpose of the Tel-Optik option – like the option proposed here – was to preserve NYNEX's ability to own the prohibited business once it had secured the necessary relief from the interLATA restriction.

The same analysis controls in all other contexts where (as with section 271) the Commission enforces ownership attribution rules in order to safeguard competition. For example, in its broadcasting and cable attribution rules, the Commission has concluded that call options and convertible rights are not cognizable ownership interests. *E.g., Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests*, MM Docket No. 94-150, at ¶ 2 n.4 (1999) ("The following corporate interests are not currently attributable: minority stockholdings in corporations with a single majority shareholder; nonvoting stock; other nonvoting instruments such as options or warrants; and debt."); *Attribution of Ownership Interest*, 97 FCC 2d 997 (1984) (adopting 47 C.F.R. § 73.3555) ("Holders of debt and instruments such as warrants, convertible debentures, options or other non-voting interests with rights of conversion to voting interests shall not be attributed unless and until conversion is effected."). The Commission adopted these attribution rules to ensure that competition is not impaired through undue concentration of ownership. Nevertheless, the Commission concluded that call options, convertible rights and other such contingent interests "exist outside the concerns and constraints of the multiple ownership rules." *Id.* ¶ 47.

Likewise, in applying the CMRS spectrum aggregation cap, the Commission has concluded that "securities affording potential future equity interests," such as call options, warrants and conversion rights, are not deemed attributable until exercised. 47 C.F.R. § 20.6(d)(5); *see also 1998 Biennial Regulatory Review, Spectrum Aggregation Limits for Wireless Telecommunications Carriers*, WT Docket No. 98-205, at ¶ 8 (1999). The CMRS spectrum cap rules – just like section 271 – are intended to promote competition and ensure that large wireless carriers do not "exclude efficient competitors, . . . reduce the quantity or quality of services provided, or . . . increase prices to the detriment of consumers." *Id.* ¶ 9.

Similarly, under the LEC/LMDS cross-ownership prohibition, "debt and interests such as warrants and convertible debentures, options, or other interests (except non-voting stock) with rights of conversion to voting interests shall not constitute attributable interests unless and until conversion is effected." *Local Multipoint Distribution Service and Fixed Satellite Services,* Second Report and Order, 12 FCC Rcd 12545 (1997) (adopting 47 C.F.R. § 101.1003(e)(5)). This cross-ownership provision prohibits incumbent LECs, including BOCs, from owning an LMDS license in-franchise. The purpose of the restriction – again, as with section 271 – is to ensure that incumbent LECs do not accumulate ownership interests that might allow them to exclude or handicap competitors. *Id.* ¶ 159.[1]

The same approach applies to statutory ownership prohibitions, as distinct from Commission-created attribution rules that are subject to waiver. In 47 U.S.C. § 310(b)(4), for example, Congress prohibited the Commission from granting a license to any corporation directly or indirectly controlled by an entity "of which more than one-fourth of the capital stock is owned of record or voted by aliens." In enforcing this statutory ban, the Commission has concluded that "future interests, such as options and convertible rights, are not relevant to our alien ownership determinations until converted." *BBC License Subsidiary*, 10 FCC Rcd 10968,

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[1] Both the spectrum cap and LMDS attribution rules allowing convertible securities contain a parenthetical exception for "non-voting stock." *See* 47 C.F.R. §§ 20.6(d)(5) ("(except non-voting stock)"), 101.1003(e)(5) (same). This exception does not mean that the Commission considers a convertible interest in stock to be fully attributable before the conversion rights are exercised. Rather, it simply means that current ownership of stock *in excess of the relevant equity threshold* will be attributable, whether or not the stock carries voting rights. This meaning is made clear by the history of these rules, which were both based on attribution rules developed in the PCS context. *See Amendment of the Commission's Rules to Establish New Personal Communications Services*, 9 FCC Rcd 4957 (1994). There, the Commission decided that non-voting stock exceeding the relevant equity threshold would be attributable, and, in discussing convertible interests, stated that "consistent with other multiple- and cross-ownership attribution standard[s], convertible debt instruments or options *with rights of conversion to equity interests* shall not be attributed unless and until conversion is effected." *Id.* at 5005-06 (emphasis added). Thus, the relevant issue for attribution purposes is the extent of the current economic interest represented by the equity held, not the extent of its convertibility.

at ¶ 20 n.12 (1995); *see also In re GWI PCS, Inc.*, 12 FCC Rcd 6441, at ¶ 10 (1997) ("Future interests are also not factored into Section 310(b) determinations."). The Commission has adhered to this approach even in cases where the foreign entity holds an option "to reacquire . . . stock in a licensee or the parent of a licensee," since the Commission recognizes that such an option does not constitute an ownership interest "until it is exercised." *In re DCR PCS, Inc.*, 11 FCC Rcd 16849, at ¶ 24 (1996).

It makes no difference to this analysis that NewCo may exercise its option without any additional payment. Consideration for the option will be given up front through NewCo's contribution of its interests in GTE-I to DataCo. Regardless of an option's exercise price, for attribution purposes, the Commission has ruled that there is "[n]o presumption that an option will be exercised." *WWOR-TV, Inc.*, 6 FCC Rcd 6569, n.13 (1991). Thus, for example, in *In re Richard R. Zaragoza*, 14 FCC Rcd 1732 (1998), the Commission, applying its newspaper/broadcasting cross-ownership rules, permitted a newspaper publisher to hold an option to purchase a 49% interest in the parent company of a prohibited television station notwithstanding the fact that the publisher paid $53,800 for the option up front and could exercise the option at any time for a token payment of $100. The Commission concluded that such "purchase options and other potential future rights are noncognizable for current attribution purposes," regardless of whether any additional payment is required to exercise the option rights. *Id.* at 1737. The Commission reasoned that the "up-front" nature of the option payment did not "warrant[] a deviation from our normal policy regarding attribution of options" because "[t]he payment does not change the fact that the option may not be exercised." *Id.* Here, too, there is a possibility that NewCo may choose not to exercise its option for economic or business reasons. Moreover, NewCo may not receive the 271 relief required to own and operate DataCo. If NewCo does not obtain 271 relief within five years, NewCo will either have to sell its convertible interest in DataCo or exercise the option and sell the offending assets of DataCo.[2]

[2] The only situation in which the Commission has treated options as attributable interests is in the spectrum auction context. *See, e.g.*, 47 C.F.R. §1.2110(b)(2); *id.* § 22.223(d)(5) (Public Mobile Services); *id.* § 24.709(a)(7) (C and F Block Licenses); *id.* § 95.816 (218-219 MHz Service); *id.* § 101.1112 (LMDS); *id.* § 101.1209 (38.6-40.0 GHz Band). That context is very different from section 271 or other contexts where the focus is on protecting competition. Where competition is the concern, eliminating *current* ownership and control is sufficient, and contingent future interests like options are permitted. (Section 271 itself explicitly anticipates that BOCs will have future opportunities to offer long distance, and the statute uses this incentive to accelerate local market opening.) In the spectrum auction context, on the other hand, concerns about the *long-term* structure of the industry are paramount – for example, the auction rules are designed to foster the development of greater diversity among license holders. Where the focus is on long-term industry structure, contingent or future ownership interests will be taken into account.

In sum, the Commission's own precedents establish conclusively that under ownership restrictions like section 271, options such as that proposed here do not constitute attributable ownership interests until they are exercised.

2. Other Relevant Federal Precedents

The decisions of federal courts and other federal agencies, including precedents under the MFJ and in the context of merger analysis under the antitrust laws, confirm that convertible rights like NewCo's are not treated as current ownership interests.

It has long been the law that "a mere option to purchase land does not vest the holder of an option with any interest, legal or equitable, in the land." *Todd v. Citizens' Gas Co.*, 46 F.2d 855, 866 (7th Cir. 1931). In a wide range of circumstances, federal courts of appeals, building on this general rule of property law, have concluded that option holders do not have rights of ownership. In *City of Ottumwa v. Surface Transportation Bd.*, 153 F.3d 879 (8th Cir. 1998), for example, the Eighth Circuit affirmed a Surface Transportation Board decision declining to determine whether an option buyer would own a target company "until such time as" the option holder "actually exercised the purchase option." *Id.* at 883. The Board reached this conclusion despite the fact that the option allowed the holder at any time to purchase a one-third interest in a company it was legally prohibited from owning.

Federal agency practice under the Clayton Act, which governs the antitrust analysis of mergers, also demonstrates that the acquisition of a call option or other convertible interest does not represent present ownership. The Clayton Act prohibits acquisitions that substantially lessen competition, but *does not* regulate the purchase of an option to acquire a target company, even for an up-front or fixed price. The reason behind this limitation is simple: It is the actual acquisition of a firm that presents a threat to competition, not the prospect of such an acquisition represented by an option. Thus, the Justice Department's and FTC's Hart-Scott-Rodino merger review regulations do not even require that option purchases be reported to the enforcement agencies – only transactions that involve the purchase of "assets" or "voting securities." 16 C.F.R. § 801.2(a). Acquisitions of "convertible voting securities" are exempt from reporting. *Id.* § 802.31. It is the "subsequent conversions of convertible voting securities" that triggers antitrust scrutiny under the Clayton Act. *Id.*

Relevant legal precedents under the MFJ also confirm that NewCo's option will not amount to ownership. Judge Greene and the Department of Justice repeatedly approved the BOCs' holding options and other conditional interests in prohibited businesses, and these conditional interests were specifically approved as a way to allow the BOCs to preserve particular business opportunities while seeking the necessary waiver of MFJ prohibitions. *See United States v. Western Elec. Co.*, No. 82-0192 (D.D.C. Aug. 7, 1986) ("Conditional Interest

Order") (setting forth standards for approval of conditional interests)[3]; Report of the United States Concerning Proposed Purchase by NYNEX Corp. of a Conditional Interest in Tel-Optik, Ltd. at 8 (June 20, 1986) ("DOJ Tel-Optik Report") ("we agree" that a BOC may acquire a contingent interest "to preserve the right to purchase the [prohibited] stock upon FCC approval and grant of a waiver application by the Court").[4]

The conditional interests approved under the MFJ typically involved the right to exercise an option (or convert debt to equity) where the price of the option or conversion rights was established, or even paid, in advance. *See, e.g.*, DOJ Tel-Optik Report at 5-6 (NYNEX would acquire a 50% interest in an interLATA cable system by repaying a 50% share of the actual construction debt to be incurred); Letter from Kenneth E. Millard to Barry Grossman, DOJ, at 3 (Sept. 16, 1986), attached to Report of the United States to the Court Concerning Procedures for Approval of Conditional Interests and Ameritech's Acquisition of a Conditional Interest in Corporation X (Sept. 19, 1986) ("Millard Letter") (funds invested up front for research and development were convertible into a fixed amount of stock defined as "the same number of shares of preferred stock . . . as the total of the development funds expended . . . up to $2.5 million would purchase in a pending preferred equity round of financing"); Letter from Thomas P. Hester to Nancy C. Garrison, DOJ, at 2-3 (July 7, 1987), attached to Report of the United States to the Court Concerning Ameritech's Acquisition of a Contingent Interest (July 15, 1987) ("Hester Letter") (initial option price was $5 million plus potential additional payments of up to $10 million; no additional payment was required to exercise the option).

These MFJ-approved options could be sold to a third party if the BOC failed to obtain a waiver. In 1986, the Justice Department reviewed and approved an option to acquire an interest in a prohibited business that Ameritech was permitted to sell to a third party after seven years. Ameritech "would retain all proceeds from such a sale up to $3 million and would share any proceeds in excess of $3 million on a 50-50 basis." Millard Letter at 4. Likewise, in 1987, DOJ reviewed and approved a second Ameritech option that was transferable after three years and allowed Ameritech to keep all proceeds from the transfer, including any appreciation in value reflected in those proceeds. Ameritech was specifically allowed to keep such proceeds even in the event it failed to obtain the necessary MFJ waiver. Hester Letter at 3.

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[3] Judge Greene's Conditional Interest Order was reversed on procedural grounds not relevant here. *See United States v. Western Elec. Co.*, 894 F.2d 430 (D.C. Cir. 1990). Nevertheless, the order spawned a body of precedent concerning options and other conditional interests that is directly relevant.

[4] In key respects, the MFJ prohibitions were stricter than section 271. The MFJ did not allow any *de minimis* ownership interest, in contrast to the 10% equity interest permitted under the statute. The 1996 Act also repealed the MFJ's prohibitions on interLATA wireless services, certain interLATA information services, royalty arrangements with manufacturers, and the selection of interLATA carriers for payphones.

The transferability of options was briefed before Judge Greene. Several interested parties (IDCMA, MCI, AT&T and U.S. Telecommunications Suppliers Association) sought review of Ameritech's 1986 option because "Ameritech's option . . . is transferable, and Ameritech would be free to sell its option to a third party without approval of the Court." Motion of IDCMA to Establish Briefing Schedule at 4 (filed Oct. 2, 1986) (footnotes omitted). The Justice Department opposed this challenge, *see* Opposition of the United States to Motion of IDCMA to Establish Briefing Schedule (filed Oct. 21, 1986), and Judge Greene permitted Ameritech to acquire the option.

Similarly, MCI challenged Ameritech's 1987 option on the ground that because "Ameritech proposes to acquire *transferable* options," it would have an "immediate equity interest," not merely a conditional interest. MCI's Protest to Justice's Report on Ameritech's Acquisition of a "Conditional" Interest in an Information Services Provider at 1 (filed July 30, 1987) (emphasis in original). Ameritech responded that it was "simply attempting to preserve an important business opportunity until it can get a waiver to engage in the new business. . . . If, after three years, it becomes apparent that Ameritech cannot obtain Court approval to exercise the option . . . , Ameritech should be permitted to liquidate its contingent position. Competition is not endangered because Ameritech may wish to *give up* its ability to enter the market." Ameritech's Response to MCI Protest at 1-2, 4 (filed Aug. 13, 1987) (emphasis in original). Again, Judge Greene refused to grant MCI's protest, and Ameritech was allowed to acquire the option.

Finally, the Justice Department approved at least one transaction, analogous to the option proposed here, where a BOC restructured a pre-existing ownership interest in a prohibited business into a conditional interest as a means of ending the violation. In May 1987, SBC bought a 21.5% voting interest in a company that engaged in research and development of specialized telephone equipment. In December 1987, Judge Greene ruled that such activities were prohibited by the MFJ's manufacturing ban. SBC sought to restructure its current equity ownership into convertible warrants that could be exercised "at a nominal price." Affidavit of Robert A. Dickemper ¶ 5 (Apr. 4, 1988), attached to Report of the United States Concerning the Proposed Retention of a Conditional Interest by Southwestern Bell Corp. (filed Apr. 15, 1988). The Justice Department approved SBC's holding the conversion rights represented by the warrants while it sought a waiver to own the prohibited business, and Judge Greene allowed the restructuring.

One factor that Judge Greene considered in analyzing whether options constitute current ownership is whether there existed any contingency to the exercise of the option. If there was a genuine possibility that the option would not be exercised by the BOC, that fact supported the conclusion that the option did not give the BOC a current ownership interest. *See* Conditional Interest Order at 5, 6-7. Here, NewCo's right to take increased ownership of DataCo will be optional, and NewCo may choose not to exercise it for business or other reasons. Moreover, NewCo's ability to own and operate the business will be contingent on receiving 271 relief. If it does not obtain the required relief within five years, it will either sell its convertible rights or exercise them and sell the offending assets.

In sum, all relevant federal precedents, including prior Commission orders and rules, make it clear as a matter of law that under the proposed structure, NewCo will not own more than the permissible 10% of DataCo for purposes of section 271 unless and until NewCo exercises its option.

B. NewCo Will Not Control DataCo.

NewCo will also not control DataCo before exercise of the option. Section 3(1) of the Communications Act does not set forth a standard for determining control, but under the Commission's precedents, control is often a factual question that turns on multiple factors or the totality of circumstances. *See, e.g.*, *Stereo Broadcasters, Inc.*, 55 F.C.C.2d 819, 821 (1975), *modified*, 59 F.C.C.2d 1002 (1976) ("The ascertainment of control in most instances must of necessity transcend formulas, for it involves an issue of fact which must be resolved by the special circumstances presented.") Analyzing the standard factors typically considered by the Commission, it is plain that the public shareholders and not NewCo will control DataCo.

Most importantly, actual control will rest with the public shareholders who will hold 90% of the voting control of DataCo. Under our proposal, it is the public shareholders, not NewCo, who will control the election of DataCo's board. Both the officers and directors of DataCo will owe fiduciary duties of loyalty and care to the public shareholders. And the public shareholders, not NewCo, will control the outcome of other decisions that are subject to general shareholder approval.

Nor will NewCo retain *de facto* control over DataCo. As the Commission has often reaffirmed, the "determinative question" in an analysis of *de facto* control is whether a party can "dominate the management of corporate affairs." *Trinity Broadcasting of Florida, Inc.*, 15 Comm. Reg. (P & F) 757 (1999). *See also Fox Television Stations, Inc.*, 10 FCC Rcd 8452, 8514 (1995) (quoting *Benjamin L. Dubb*, 16 F.C.C. 274, 289 (1951)). Here, it is absolutely clear that NewCo cannot dominate the management of DataCo's affairs while it owns only 10%. DataCo will be operated and managed independently from NewCo, and NewCo will have no right or ability to control or replace the managers of DataCo or participate in any way in the day-to-day management and operation of its business.

Other relevant factors in the *de facto* control analysis include whether the allegedly controlling party receives monies and profits derived from the operation of the facilities; whether that party is in charge of the payment of financing obligations, including operating expenses; and whether it has unfettered use of all facilities and equipment. *See, e.g.*, *Intermountain*

Microwave, 24 Rad. Reg. (P & F) 983, 984 (1963). These additional factors further confirm that the investing public and not NewCo will control DataCo. First, NewCo will not derive more than a 10% share of the profits or other economic returns of DataCo's business before the option is exercised. Second, DataCo (not NewCo) will be responsible for its own financing. If DataCo wishes to obtain financing from NewCo, it will have to do so through an arm's-length commercial loan. Finally, DataCo's management and board of directors will control the use of all facilities and equipment of DataCo.

This conclusion is not affected by the investor protections relating to fundamental business changes that will safeguard NewCo's rights as an option holder and minority investor. Such provisions are ordinary and reasonable investor safeguards and are precisely the kind of protections that any option holder or other prospective acquirer would have with an executory purchase agreement. Indeed, NewCo could reasonably obtain such purchaser safeguards if DataCo were *already* an independent public corporation and NewCo entered into an executory contract today to acquire 80% of DataCo after receiving 271 relief. The only distinction in the present situation is that here GTE/Bell Atlantic already owns GTE Internetworking instead of simply acquiring an option in an independent company – a distinction that makes no substantive difference to whether NewCo will control DataCo.

Numerous Commission rulings clearly establish that these sorts of investor protections do not constitute control.

As the Commission has repeatedly ruled, provisions such as these "fall within the scope of accepted purchaser safeguards that the Commission has previously found not to constitute a premature [license] transfer." *In re Applications of Puerto Rico Telephone Auth., Transferor, and GTE Holdings (Puerto Rico) LLC, Transferee*, 14 FCC Rcd 3122, ¶ 44 (1999). In its *Puerto Rico Telephone* order, the Commission specifically approved "limitations on the target compan[y's] entering into new lines of business, making substantial and material alterations to current contracts or agreements, disposing of material assets, and making substantial outlays of capital." *Id.* (citing specific license transfer precedents approving such protections).

The Commission has also consistently ruled that reasonable investor protections do not confer control for purposes of the Commission's attribution rules. For example, in *In re Applications of Roy H. Speer, Transferor, and Silver Management Co., Transferee,* 11 FCC Rcd 14147 (1996), the Commission ruled that a third party who held certain contractual veto rights over fundamental business changes did not have an attributable interest in a corporation. Similarly, in *Applications of Quincy D. Jones, Transferor, and Qwest Broadcasting, LLC, Transferee,* 11 FCC Rcd 2481 (1995), the Commission allowed a party who was prohibited from exercising control over a corporation nevertheless to hold supermajority voting rights concerning certain fundamental corporate decisions. The Commission explained that "[t]he right to participate in matters involving extraordinary corporate actions . . . does not ordinarily undermine the nonattributable character of otherwise noncognizable interests, so long as the voting rights or licensee obligations are narrowly circumscribed." *Id.* ¶ 19.

In cases such as these, the Commission has specifically approved veto or supermajority voting rights over fundamental business changes such as: the sale or acquisition of significant assets outside the ordinary course; any merger or consolidation; the assumption of significant new debt; material changes to the corporate charter or by-laws; the payment of dividends in excess of profits or the issuance of new securities; the formation of new subsidiaries; entering into new lines of business; and significant transactions with other shareholders or interested parties. *See, e.g.*, *Roy H. Speer*, 11 FCC Rcd 14147, at ¶ 18; *Quincy D. Jones*, 11 FCC Rcd 2481, ¶ 9.

These Commission precedents are on all fours and dispose of any doubt as to whether such investor protections will give NewCo control of DataCo within the meaning of section 271.[5] The narrowly circumscribed covenants and charter provisions proposed here will come into play, if at all, only in a narrow category of extraordinary circumstances and will otherwise have no impact on the general conduct of DataCo's business.

II. The Proposed Structure Is Fully Consistent With the Policies Behind Section 271.

The above discussion is sufficient to establish that under the applicable legal standards, DataCo will not be an "affiliate" of NewCo under sections 271 and 3(1) of the Act.

[5] Precedents under the MFJ also demonstrate that similar protective covenants were repeatedly permitted to BOCs in connection with conditional interests in prohibited businesses. *See, e.g.*, Letter from Richard W. Odgers, Pacific Telesis, to Nancy C. Garrison, DOJ, at 3 n.5 & 4 n.6 (Mar. 15, 1989) (describing Pacific's contractual rights in option agreement to prevent assumption of excessive debt and "approve or disapprove of certain fundamental changes in the business" pending approval of MFJ waiver), attached to Report of the United States to the Court Concerning the Proposed Acquisition of a Conditional Interest By Pacific Telesis (filed Apr. 24, 1989); Letter from Thomas P. Hester, Ameritech, to Nancy C. Garrison at 3 (July 7, 1987) (describing Ameritech's contractual rights under option agreement to prevent the target company from changing its business in a way that adversely affected Ameritech's rights, "engag[ing] in transactions with affiliates on other than commercially reasonable terms," or "mak[ing] cash distributions that would adversely affect its ability to conduct business"), attached to Report of the United States to the Court Concerning Ameritech's Acquisition of a Conditional Interest (filed July 15, 1987); Letter from Kenneth E. Millard, Ameritech, to Barry Grossman, DOJ, at 3 (Sept. 16, 1986) (describing contractual covenant providing that, before the target company "could be acquired by any central office equipment manufacturer or by any manufacturer of computers with annual revenues in excess of $5 billion," Ameritech "would have the right, if permissible, to purchase all of [the target company's] business and assets"), attached to Report of the United States to the Court Concerning Procedures for Approval of Conditional Interests and Ameritech's Acquisition of a Conditional Interest in Corporation X (filed Sept. 19, 1986).

Accordingly, the public corporation and option structure we have proposed will completely resolve the only legal issue raised under section 271. In addition, we believe that our solution is also fully consistent with the underlying policies of section 271.

This proposal will preserve and even enhance NewCo's incentives to comply fully and expeditiously with the 271 checklist requirements. NewCo will retain the same baseline incentive that all BOCs have to comply with 271 in order to gain in-region entry into the lucrative market for traditional voice long distance service. Furthermore, the five-year limitation on the exercise of NewCo's option, and the accompanying risk that NewCo will lose its ability to get GTE's valuable data business back, will create a powerful additional incentive for NewCo to hurry up and complete the 271 process in its remaining in-region states.

As NewCo moves forward with the 271 process, moreover, there is no significant risk that NewCo's BOCs will engage in discrimination in favor of DataCo. First, the nature of the Internet and related data businesses involved here ensure that, as a practical matter, there is little likelihood of discrimination. Presently, GTE Internetworking is not significantly dependent upon access to LEC local loops, switching, central office space or other core LEC facilities; its purchase of traditional local loops is limited to the provision of wholesale DSL service to ISPs, a business that accounts for less than 1% of GTE-I's revenues. The primary inputs GTE-I purchases from BOCs and other LECs are point-to-point circuits, principally DS-1s and DS-3s. In many locations, including the larger metropolitan areas where many of GTE-I's business customers are located, such circuits are available from multiple providers on a competitive basis.

Second, in those areas where a Bell Atlantic BOC is the only available provider of point-to-point circuits for DataCo, the risk of discrimination will be readily addressable. DataCo will purchase all such circuits on a tariffed basis, which will ensure that DataCo is not advantaged by discriminatory pricing. And any effort by NewCo to advantage DataCo in the timing or quality of provisioning of these circuits would be easily policeable by the Commission and competitors of DataCo.

Third, what is most important to consider is the impact on NewCo's *net* incentives, and our proposal ensures that the incentive to comply with 271 will remain dominant. NewCo would have very little to gain and everything to lose if it acted anticompetitively to advantage DataCo. Discriminatory behavior by NewCo could confer only a small and highly contingent benefit (especially given that DataCo is not even expected to earn a profit and pay dividends to NewCo for years to come). On the other hand, far outweighing that remote benefit is the fact that NewCo would run an enormous risk if it pursued a concerted effort to discriminate in favor of DataCo. Any hint of such discrimination would surely be trumpeted by opponents of 271 authority and could complicate or delay future 271 approvals, thus threatening NewCo's ability to exercise its option to retrieve ownership and control of DataCo. Evidence of such discrimination would likely also be used by such opponents as a basis to seek penalties from the

Commission against NewCo, perhaps even including urging the Commission to impose the ultimate penalty – rescission of 271 approvals previously granted. It would be irrational for NewCo to run any such risks.[6]

Fourth, the theoretical risk of discrimination under the proposed structure is no greater than what Congress implicitly determined was acceptable under the Communications Act, since, as discussed above, sections 3(1) and 271 permit BOCs to hold both a 10% ownership interest and an executory option. Indeed, any such risk of discrimination here will be significantly less than what might be supposed to exist if NewCo held a 10% interest in a traditional IXC engaged in the provision of conventional voice long distance service.

Beyond the issue of discrimination, the option structure we have proposed, which will separate GTE-I from NewCo until NewCo has received 271 relief, is particularly well-suited to the fundamental design and objectives of section 271. The 271 interLATA restriction is temporary in nature; it is designed to fall away once NewCo satisfies the checklist requirements in the Bell Atlantic states. This restriction is very different from a prohibition, such as a horizontal cross-ownership prohibition, that is permanent or incapable of being fixed. Thus, in terms of the underlying statutory policies at issue, an option is even more appropriate here than in other regulatory or statutory contexts where similar arrangements have already been approved by the Commission.

Finally, the proposed arrangement will not automatically be applicable to other transactions or other contexts. This proposal is put forward in the context of a merger that involves primarily non-interLATA businesses. GTE Internetworking currently accounts for less than 2% of GTE/Bell Atlantic's combined revenues. Furthermore, the arrangement we propose is narrowly tailored to address the unique factual circumstances and competitive interests raised by GTE-I's role as an Internet backbone provider. Preserving NewCo's ability ultimately to take

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[6] Once again, MFJ precedents are relevant on this point, because the risk of discrimination was a factor considered by Judge Greene in approving similar conditional interests. *See* Conditional Interest Order at 5, 7. Under the MFJ, the Justice Department recognized that it "might be argued" that the "anticipation of a future interest" created by an option "may increase [the BOC's] incentive to discriminate against existing or potential competitors in providing access to the local exchange during the interim period." DOJ Tel-Optik Report at 12 n.10. Nevertheless, the Department concluded that "[s]uch behavior . . . is unlikely to occur in view of the fact that the Department and interested parties will be reviewing [the BOC's] waiver application during the very period when any such discriminatory activity would occur." *Id.* Judge Greene agreed, concluding that where the conditional interest could not be exercised without the granting of a waiver, "the legal obstacles to anticompetitive conduct are decisive." Conditional Interest Order at 7. Likewise, here, the availability of the 271 review process and the substantial risk that anticompetitive conduct by NewCo would jeopardize its ability to achieve or retain 271 approvals should thoroughly dispel any concerns about discrimination.

back ownership and control of GTE-I will enable GTE-I to remain the only independent, non-IXC-owned top-tier Internet backbone, which, in turn, will help protect the fragile state of equilibrium among peering backbones that is critical to healthy competition throughout the Internet.

Conclusion

For all of the foregoing reasons, the Commission should conclude that the public corporation and option structure proposed by GTE/Bell Atlantic will eliminate any 271 issue relating to GTE Internetworking that is caused by the GTE/Bell Atlantic merger.