seek access to the trust assets until after it obtained Section 271 authority. Such a transaction, which would rest on the same false premise on which Applicants rely here, would be patently unlawful – and for good reason, for both of the central incentives that Section 271 seeks to address would be adversely affected. Specifically, the BOC would have a strong incentive to discriminate in favor of its chosen long distance carrier, so as to maximize the profits it would obtain when it later "cashed in," and the BOC simultaneously would have less of an incentive to open its local markets speedily, because the ability to rack up profits in the long distance market that it would subsequently realize would take much of the bite out of being otherwise excluded from that market. Thus, whether examined from the perspective of Section 3(1) or Section 271, Applicants' commitments to dispose of sale proceeds in various ways and defer obtaining access to prior years' appreciation have absolutely no legal significance.[25]

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[25] One other aspect of their revised proposal warrants comment. Although Applicants have told the press that AT&T would not have a "prayer" of winning an appeal of a Commission order approving their proposal, *see Bell Atlantic-GTE Pledge More Limits on Internet Sale*, Bloomberg (Apr. 28, 2000) (quoting John Thorne), they have nonetheless included in their latest proposal a provision that purports to tell the Court of Appeals what remedy would be imposed if the Court of Appeals issued such a decision. Specifically, Applicants state that they would be permitted to keep a substantial portion, if not all, of the appreciation gains in Genuity from the prior period (up to an amount equal to the return of the S&P 500) and that they would also have a "reasonable time" to divest. *See* April 28 Submission, Exh. A, at 6-7. Aside from being extraordinarily presumptuous, that assertion is also wrong. In particular, Applicants would have as much time as they wished to divest Genuity – but upon such a Court decision Genuity would immediately have to cease providing interLATA service until that divestiture. Neither the Commission nor the Court has the statutory authority to permit Bell Atlantic to provide long distance service for any period of time, whether "reasonable" or not, in the absence of Section 271 approval from the Commission. *See* 47 U.S.C. § 160(d).

II. APPLICANTS WOULD CONTROL GENUITY

The conversion right would not merely be the source of Applicants' prohibited ownership interest in Genuity. It would also be the principal mechanism by which Applicants would have impermissible control over Genuity. Applicants' most recent modifications leave that mechanism – and thus their control – untouched.

Indeed, Applicants continue to deny categorically that options *can* convey control, and their position would require the Commission to hold that options can never do so. As Professor Gilson has stated, "because," in his view, "an option conveys no *current* ownership, it conveys no capacity to influence the conduct of another entity. . . ." *See* Gilson Second Supp. Dec. ¶ 5 (emphasis in original); *see also* Gilson Supp. Dec. ¶ 11 (an option "conveys no capacity to control the actions of another entity"). Applicants are compelled to take an absolutist and categorical position on this question, of course, because if *any* option could convey control, their extraordinary 80% conversion right – for a company already consisting of their former officers and employees – would certainly do so.

But it is nonsense to suggest that options can never convey control, and such a holding would be as breathtakingly far-reaching as it would be wrong and unprecedented. As Professor Coffee has explained,[26] and as the Commission, other expert agencies, and courts have all found,[27] options to acquire a sufficiently significant interest in a company give the holder the ability to exercise control over that company. This proceeding presents a particularly plain illustration of

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[26] Coffee Dec. ¶¶ 26-30; Coffee Supp. Dec. ¶ 8.

[27] *See, e.g., Cable Attribution Order* ¶ 129 n.329; *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 363-64 (S.D.N.Y. 1998); *Walson & Co.*, 7 SEC 937, 947-51 (1940).

the point. Genuity will be populated with former Bell Atlantic and GTE employees that will be fully aware that they will soon be part of the Bell Atlantic/GTE corporate family once again. Furthermore, contrary to Applicants' assertion that Genuity's managers will not have "incentive compensation" tied to the "financial performance or stock value of [BA-GTE],"[28] many of Genuity's managers already have stock options in Bell Atlantic/GTE.[29] These managers would have powerful economic incentives to advocate policies that further Applicants' interests and to refuse to enter into arrangements with entities that could offer Applicants substantial competition. *See* Coffee Third Dec. ¶ 13.

But it is not simply that Genuity's managers and employees would have powerful personal incentives to act consistent with Applicants' plans and wishes, although that is certainly the case. Genuity as a firm would also have similar incentives. *See id.* ¶ 14. Because Genuity would soon formally be part of Applicants' corporate family once again, the only rational approach for Genuity to take would be to adopt strategies and policies that are consistent with and complement Applicants' business plans. Conversely, it would be a waste of assets for Genuity to dedicate resources to a venture that is inconsistent with Applicants' plans, because any such venture would have to be discontinued as soon as the reintegration occurred. It would thus be irresponsible for Genuity to develop and implement any long-range business plan that did not take that reintergration centrally into account.

In addition to their conversion rights and the effect of the resulting expectation of reintegration, Applicants have established several other mechanisms that would grant them

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[28] April 28 Submission, Exh. A, at 2.

[29] *See, e.g.*, GTE Corp. Proxy Statement (Apr. 14, 1999), at III-3 – III-5.

control. First, they continue to have veto rights, albeit somewhat modified, through the "Investor Safeguards." Applicants' claim that these veto rights are "ordinary and reasonable" for an option holder, BA-GTE Supp. Filing at 45, cannot be taken seriously, because the so-called "Investor Safeguards" would vest substantial control rights in Applicants *independent* of their ownership of Class B shares. Only a few of the Investor Safeguards attach to the Class B shares themselves. The remainder attach to "NewCo" (*i.e.*, Bell Atlantic/GTE) directly. *See* April 28 Submission, Exh. C. In other words, even if Applicants sold most of their Class B shares, Genuity would still have to go to Applicants, not the new Class B shareholders, to obtain consent for issuing dividends and distributions, issuing shares, many acquisitions and dispositions and the incurrence of certain levels of debt. *See id.* That confirms that these provisions have nothing to do with protecting Applicants' "investment," but rather are designed to give them control apart from their investment. *See* Coffee Third Dec. ¶ 19.

Second, Applicants' "commercial contracts" continue to present a vehicle for control, because Applicants designed contracts that impose binding legal obligations on Genuity and that would require Genuity to follow the path they have charted. *See* Coffee Third Dec. ¶¶ 14, 16. The "Purchase, Sales and Marketing Agreement" provides a particularly vivid example. This contract would bind Genuity for the next five years – the period in which Genuity is supposed to be "independent" – with regard to the prices it will be permitted to charge Verizon (apparently its largest expected customer) for its most important services. In an ordinary commercial relationship, the buyer is not given the right to draft long term sales contracts that bind the seller. By determining in advance the rights and obligations that will govern Genuity with regard to Genuity's services, Applicants will be unilaterally deciding Genuity's pricing policies over the next five years.

Finally, Applicants' revised proposal does nothing to address the import of the Commission's five percent voting equity benchmark for control. As AT&T has explained,[30] the Commission has repeatedly found in both the cable and broadcast contexts that holding more than 5% of the voting stock of a company gives the investor "control" over that company.[31] Here, Applicants would hold instruments that would give them a nearly 10% voting interest.[32]

III. APPLICANTS' PROPOSAL IS CONTRARY TO THE PURPOSES OF SECTION 271 AND SOUND POLICY

Although this issue is one of law and not of policy, it remains the case that Applicants' proposal would be bad policy and would frustrate the objectives of Section 271. This is a case in which the law and policy point to the same result. Four points warrant emphasis.

First, and contrary to Applicants' claim, BA-GTE April 3, 2000 *Ex Parte* at 22, this proposal cannot be defended on the ground that Genuity is only a "data" company. Even if there were a cognizable distinction under Section 271 between "data" and "voice" (and there is not)

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[30] AT&T March 10, 2000 *Ex Parte* at 8 n.8; AT&T March 22, 2000 *Ex Parte* at 17.

[31] Report and Order, *Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS* Interests, 13 FCC Rcd. 12599, ¶ 10 (1999); *Cable Attribution Order* ¶¶ 45-50.

[32] Applicants' only response has been to claim that the principles underlying the Commission's 5% rule cannot be applied here because of "the plain language of section 3(1), which expressly permits the owning of any equity interest up to 10% (whether voting or nonvoting)." BA-GTE March 14, 2000 *Ex Parte* at 16 (emphasis deleted). That is simply wrong. By its plain terms, the statute only permits a BOC to acquire up to a 10% "equity" interest in a company if that interest does not also give "control." Simply because a 10% voting interest is not ownership under the statute does not mean that this interest automatically passes the control test too, and, to the contrary, the Commission has concluded that a 5% voting interest automatically creates control. Further, it is easy to harmonize the two provisions once it is recognized that an "equity" interest is not synonymous with the voting stock that is the focus of the Commission's rule. There are numerous other equity interests that BOCs can acquire without triggering the Commission's 5% equity voting threshold for control, such as preferred stock and limited partnership interests.

that distinction would have no application here. Although Applicants repeatedly sought to suggest that only data services were at issue – dubbing the spun-off company "DataCo," and contending that its business would be "limited to the provision of Internet and related data services," *id.* – that was and is not so. The documents filed by Applicants in this proceeding show that GTE intends to transfer to Genuity assets that generate over $100 million a year in traditional voice services, such as private line services and resale of long distance capacity. BA-GTE April 18, 2000 *Ex Parte* at 1-2. The IPO registration statement filed by Genuity with the SEC[33] and Genuity's statements to the market[34] likewise confirm that voice services are an integral part of its business.

Moreover, the reason that Section 3(1) and Section 271 do not recognize a distinction between data and voice is that voice traffic can be "digitized" and transported as data traffic. Thus, data networks can and do transmit voice signals. This is also true of packet switched data traffic – *i.e.* IP data traffic. Genuity currently uses voice over IP technology to offer traditional services using its Internet backbone facilities and has boasted that it expects this business to be a major source of future earnings.[35] According to Genuity's press statements, "[t]he market is rapidly evolving toward an IP-based converged data and voice network, and the demand for Voice over IP and enhanced IP services is exploding."[36] There can be no question that the Commission's decision here will apply to both data and voice.

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[33] Genuity Inc. S-1 (Apr. 7, 2000), at 27, 39-41.

[34] http://www.genuity.com/services/transport.

[35] http://www.genuity.com/services/ipservices/voip; http://www.genuity.com/announcements/news/press_release_19991020-01.xml.

[36] http://www.genuity.com/announcements/news/press_ release_19991011-01.xml.

Second, Bell Atlantic already has the ability to discriminate against long distance companies, and an affiliation with one particular long distance company would give it the incentive to do so. In particular, even beyond the well-documented ways in which Applicants could use their bottleneck facilities to disadvantage Genuity's voice competitors, Applicants can also use their dominant position to disadvantage Genuity's Internet backbone competitors. Applicants concede that in many areas Genuity and other Internet backbone providers are dependent upon Bell Atlantic's monopoly facilities for necessary transport services. BA-GTE Supp. Filing at 51. That gives Bell Atlantic the ability to delay and degrade service to unaffiliated competitors of Genuity.

Applicants' sole defense on this point is to blandly assert that any such discrimination would be "easily policeable." *Id.* But that assertion is simply a collateral attack on Section 271. Section 271, like the MFJ before it, bars the BOCs from the long distance market because it long ago became clear that detecting and proving such discrimination is, contrary to Applicants' claim here, extremely difficult – consider the encyclopedic performance measures that have had to be developed to begin doing so in the local market – and because a mere prohibition against discrimination is woefully inadequate to prevent favoritism by a vertically integrated BOC that controls essential inputs to its competitors' services.

Third, this proposal would also give Bell Atlantic substantial incentives to delay opening its local markets to competition. Unlike every other BOC, Bell Atlantic would be able to derive substantial long distance revenues even while it is formally excluded from the market, because Genuity would be operating and Bell Atlantic would subsequently capture the appreciation attributable to that period. Bell Atlantic's incentive to start opening its local markets to competition would return to its prior level only as the five year mark approaches.[37]

Finally and most fundamentally, the construction of the Act that Applicants propose obviously could not be confined solely to Applicants' transaction. The reason statutes routinely extend regulatory requirements and agency jurisdiction not only to particular types of firms but also to their "affiliates" is to ensure that regulatory strictures cannot be circumvented through matters of corporate form. If the Commission were to exempt from those strictures arrangements with options – particularly arrangements with "non-option options" like this one – on the extraordinary grounds that options are not equity and thus options cannot convey control, then it will quickly start seeing many more such arrangements and many more such "options," and it will have established a new roadmap for regulatory evasion. *See* Coffee Third Dec. ¶¶ 4, 6.

[37] It is no answer to say, as Applicants have, that if they discriminate against other carriers during the five-year period they will be denied long distance authority and will be unable to recover Genuity. That is not so. In deciding a Section 271 proceeding, the Commission generally does not consider the BOC's conduct one, two, or three years prior to the application. Rather, it looks at performance data from a few months back to determine the current state of affairs. *See, e.g., Bell Atlantic New York Order* ¶¶ 269, 283-84, 197-201, 293-96.

CONCLUSION

For the reasons stated above, and those in AT&T's prior filings, the Commission should hold that Applicants' revised proposed transaction would be unlawful.

Respectfully submitted,

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May 5, 2000

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of May, 2000, I caused true and correct copies of the foregoing Opposition of AT&T Corp. to Applicants' Revised Proposal Regarding GTE's InterLATA Operations and Comments of AT&T Corp. on Applicants' Revisions to Proposed Merger Conditions to be hand served on all parties listed on the attached service list.

Dated: May 5, 2000
Washington, D.C.

Peter M. Andros

Peter M. Andros

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EXHIBIT A

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter	)	
	)	
GTE CORP.	)	
	)	
Transferor,	)	
	)	**CC Docket No. 98-184**
and	)	
	)	
BELL ATLANTIC CORP.	)	
	)	
Transferee,	)	
	)	
For Consent to Transfer of Control	)	

THIRD DECLARATION OF JOHN C. COFFEE, JR.

1. I am the Adolf A. Berle Professor of Law at Columbia University Law School, and I make this declaration, which supplements my two earlier declarations in this proceeding, dated March 10, 2000 and March 21, 2000, respectively, in response to the April 28, 2000 filing by Bell Atlantic Corp. ("Bell Atlantic") and GTE Corp. ("GTE"; collectively, "BA-GTE") of a modified proposal for the capital and board structure of Genuity, Inc. (formerly GTE-Internetworking). In this connection, I have reviewed the April 28, 2000 letter of Mr. William P. Barr, Executive Vice President and General Counsel of GTE, along with the Exhibits thereto, and the April 18, 2000 Public Notice of the Commission.

2. To summarize my conclusions briefly, I find that very little has changed. First,

the Class B shares remain convertible into at least 80% of Genuity's ownership[1] on a basis that is essentially within BA-GTE's control and is thus riskless; accordingly, the conversion right (which BA-GTE persist in calling an option) remains in my view a "non-option." But even if there were real risk associated with the event that triggers this option, it would remain an equity instrument, with the degree of risk only affecting its value and BA-GTE's level of ownership. Because the sum of the parts must equal its whole, the equity interest of BA-GTE in Genuity cannot be 10% or less (as required by Section 271 of the Communications Act) unless the ownership of the Class A shareholders is truly 90% or more. Yet, as shown in more detail in the Declaration of Dr. Richard N. Clarke, it is only if there were a greater than 99% probability that BA-GTE would be unable to satisfy the option's triggering condition that the value of the Class A shares would reach or exceed 90% of the total value of Genuity (and that correspondingly the value of the Class B shares would fall to 10% of the value of Genuity). Finally, whatever the level of BA-GTE's ownership of Genuity, the modest refinements in the April 28th revised proposal do not address AT&T's other principal objection: namely, that BA-GTE controls Genuity -- both by means of its "non-option" and by other mechanisms. Indeed, as discussed below, the revised proposed demonstrates in its unique Class C shares that the relationship between BA-GTE and Genuity is

1 With regard to this much used 80% figure, I must note that Genuity's April 7, 2000 Registration Statement on Form S-1 for its proposed initial public offering indicates that on conversion of the Class B shares BA-GTE will own 82% of Genuity's capital stock and 96% of its total voting power. Although the difference between 80% and 82% can be explained by the underwriters' overallotment options, the discrepancy between equity ownership and voting power has not been explained. The fact that BA-GTE has given itself greater than proportionate voting power is further evidence of its control relationship with Genuity, as disproportionate voting power is probably the oldest technique for locking up control.

not that of an ordinary investor or option holder with a company in which it has a speculative investment, but rather is a controlling relationship that BA-GTE are actually unwilling to pass on to any prospective purchaser of their Class B shares.

I. THE OWNERSHIP ISSUE

3. At my April 7, 2000 appearance before the staff, I argued that Class B shares did not amount to an option in any meaningful sense, but rather was a "transparent stock parking arrangement" in which BA-GTE hid 70% of the equity value of Genuity from the Commission (but not from the market). In so concluding, I emphasized seven factors: (1) the "option" was costless in that it had no exercise or conversion price; (2) the option was riskless; (3) BA-GTE's real ownership was broadcast to the market, which understood that the Class A shares would represent only approximately 20% of Genuity's economic value; (4) this was an option negotiated by BA-GTE with BA-GTE and not with any real counterparty; (5) the option carried control rights, unlike any real world option; (6) the option was not contingent, but was certain to be exercised (it was thus "non-optional"); and (7) the option would be deemed to give BA-GTE beneficial ownership of the underlying equity under the SEC's beneficial ownership rules. The revised April 28th proposal attempts to respond to these criticisms by addressing only the factors of risk and contingency; it attempts to do so by making the option contingent upon a "real world" event, but one which is largely subject to BA-GTE's control.

4. Before even examining the actual contingency that triggers the conversion feature, it should be questioned in the abstract whether the Commission wants to legitimize and encourage such a transaction structure (which, if approved, will certainly be copied by others). For example, if simply adding a contingency to an otherwise costlessly convertible security enables the holder of

the security to hold a permissible 9.5% until that contingency occurs (or does not occur), the next party to follow this technique might provide that it could convert its 9.5% ownership into 95% ownership at any time for five years if (a) the Dow Jones Industrial Average did not fall below 3,000, (b) the Chicago Cubs did not win the World Series, or (c) U.S. GNP rose by more than 1% over the period. Perhaps these events seem frivolous, but we are considering in principle whether a regulated entity should be able to use the occurrence of a contingent event as the basis for denying ownership of equity that may costlessly be acquired by it on the occurrence of that event. Once this conceptual leap is made, the "contingent" character of the events will become progressively more certain. Indeed, this technique could easily become not a loophole, but a triumphal arch, for transaction planners. For example, Mr. Rupert Murdoch's foreign corporation in the Fox Television cases might have recast that transaction so that it held a convertible option with the triggering event being either highly probable or within its control.

5. The absence of any material contingent risk in this case can be inferred from the Commission's own prior statements. Here, BA-GTE's right to convert its Class B shares into Class C shares becomes exercisable (subject to an economic "forfeiture" provision that I will discuss later) at any time within five years if it eliminates the applicable Section 271 restrictions as to 50% of Bell Atlantic's lines. Although I do not purport to be an expert on the Communications Act, I have seen a series of decisions in which the Commission has essentially said that any BOC has the power to satisfy Section 271's requirements if it desires to do so. For example, in its Memorandum Opinion in Application of Ameritech Michigan Pursuant to Section 271, 12 FCC Rcd 20543 (1997), the Commission wrote that the Communications Act "places in each BOC's hands the power to determine if and when it will enter the long distance market"

because "it is the BOC's willingness to open its local telecommunications markets to competition pursuant to the requirements of the Act that will determine Section 271 approval." (Id. at Para. 23). If the Commission was correct (and I assume it to be), then the conversion feature is virtually riskless because it requires only a good faith effort by Bell Atlantic. Thus, in my judgment, BA-GTE have in substance parked 70% of the ownership of Genuity in a legal limbo subject to their power to claim that 70% whenever they wish to satisfy a condition within their control.

6. Other transaction planners will not miss the significance of any decision giving decisive weight to such a "riskless" risk. Form/substance games can be contemplated not only under Section 271 but under other provisions which specify ownership limits, because (unlike in the case of tests relating to control or other more judgmental factors), the Commission has little discretion with respect to the legal meaning of ownership once it were to rule that an option contingent on a "riskless" or low risk event deprived the option owner of equity ownership. To say the least, to legitimize such a planning device is for the Commission to willfully paint itself into the corner across a variety of legal contexts.

7. I anticipate that BA-GTE will respond that they must obtain not a 50% threshold, but a 95% threshold before they can enjoy the economic benefits of their conversion right. This is because, under BA-GTE's self-designed penalty, they are deprived of any appreciation on the sale of their option to a third-party that is in excess of "our initial investment plus an S&P 500 return." See Barr Letter, April 28, 2000, at p. 1. There are a number of problems with this forfeiture provision, as with all self-designed and self-imposed penalties. First and most fundamentally, whether the test is 50% or 95%, it is still within BA-GTE's control, and there is no evidence that

this is a difficult test to satisfy over a five year period. Moreover, it was precisely this 95% test that the Commission was referring to in the Ameritech Michigan Order (and other decisions) when it said that compliance with Section 271 was in the hands of each BOC.

8. Second, the proposed "penalty" is far less "painful" than the Commission may realize. In the first instance, this is because the stock prices of both Bell Atlantic and GTE have been closely correlated with the S&P index over the last five years. As the two attached charts (Appendices 1 and 2) show, the stock prices of both Bell Atlantic and GTE have virtually shadowed the S&P index over that period (with the S&P index doing slightly better than each). Thus, if GTE's stock price has been a proxy for Genuity's stock price, BA-GTE would be able to sell its option to a third-party and keep the entire proceeds. To be sure, Genuity's stock price might well deviate from BA-GTE's stock price or from the S&P index. Indeed, this is fairly predictable. One of the most frequently observed regularities in financial economics is that the stock price of a company in an initial public offering (or "IPO") tends to underperform the market for equity securities in the period following the IPO. That is, IPOs often achieve fantastic first day stock price returns (largely because of underwriter underpricing), but thereafter they consistently underperform the equity market for a sustained period.[2] This pattern has continued even during the current market boom, with the Wall Street Journal recently reporting that the

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[2] For some of the numerous studies on this point, see Jay Ritter, The Long Term Performance of Initial Public Offerings, 46 J. Fin. 3 (1991); Carter, Dark & Singh, Underwriter Reputation, Initial Returns and the Long Run Performance of IPO Stocks, 53 J. Fin. 285 (1998); T. Loughran & J. Ritter, The New Issues Puzzle, 50 J. Fin. 23, 32 (1995).

average initial public offering conducted during 1999 had fallen over 4% from its first day close.[3] Of course, Genuity may not be like the typical IPO. But, if its greater size and maturity differentiate it from other IPOs, then this may correspondingly imply that Genuity's stock price is more likely to follow the stock price performance of GTE from which it has been carved out; as just noted, GTE's stock price has largely paralleled the S&P index. Thus, whether Genuity is analogized to a large company or a small one, this penalty may well prove painless.

9. Still other problems can also be identified with this provision. If for any reason BA-GTE saw that they would be unable to satisfy the 95% test, they might protect themselves by buying derivatives (including equity swaps) on Genuity's Class A shares. Or, they might sell their Class B shares to a third-party at a deliberate discount in return for a compensating gain on a related reciprocal transaction. Put simply, at this point, there are few teeth in, or safeguards surrounding, this proposed penalty provision, and it might be evaded by a variety of techniques. Somehow, it seems ironically appropriate that a "non-optional option" be protected by a "painless penalty."

10. Even if this "forfeiture" provision is not viewed as a penalty but as an attempt to restore BA-GTE to where they would have been if they had initially divested their entire interest in Genuity, the significance of this provision still looms large because it effectively enables BA-GTE to "play both sides of the street" for an extended period. In effect, BA-GTE are given the

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[3] See Ewing, "Burnt Offerings? Street Debuts Fizzling After Pop -- Average IPO Since '99 Has Notched a 4.3 % Fall From First Day Close," Wall Street Journal, April 26, 2000 at C-1. The Journal's numbers may well be overstated (as the Journal subsequently admitted chiefly because of a failure to account for stock splits), but, even as corrected, the returns on IPOs after the first day clearly do not outperform the equity market.

right for five years (and possibly six years) to decide for themselves whether they wish to "open the local telecommunications market to competition" (in the language of the Ameritech Michigan Order). Over this period, they can balance the possible gains from holding an 80% interest in Genuity for the long term against the possible losses in their local markets from increased competition. If they decide that the gains are not worth the costs of fully opening their markets, they can instead sell their Class B shares and receive in all likelihood most of their economic value. In reality, BA-GTE gain the right to "have their cake and eat it too" for a multi-year period. This analysis is particularly apt where, as here, Bell Atlantic has already partially opened its local markets to competition (i.e., in New York) and thus does not have far to go to meet the 50% level at which the ability to sell the Class B shares, subject to its painless penalty, is triggered.

11. More fundamentally, Even if one believes that the proposed forfeiture penalty is not painless, this conclusion does not change the character of BA-GTE's convertible Class B shares into something other than an equity instrument. Effectively, BA-GTE obtain the right to convert a 10% interest into an 80% interest, subject to an alleged "downside" possibility under which they may be forced to sell their equity interest and split the proceeds on the 70% portion with a silent partner (the U.S. government). This gain-splitting agreement is essentially a side agreement between the Class B shareholder and a third party and does not involve Genuity or its Class A shareholders. Indeed, the arrangement is not significantly different from a transaction in which a similarly positioned shareholder pledged its shares to a financing bank or other institution under some other gain-splitting arrangement. In such a case, such shareholder would remain the

beneficial owner (even though others were entitled to a share of its profits) because it held both the voting and disposition power over the shares.

12. Throughout my submissions and at the April 7th discussion before the Commission's staff, I have consistently urged the Commission to treat options and conversions rights in the same manner as does the Securities and Exchange Commission. Because I have previously shown that the SEC's rules under Section 16(b) of the Securities Exchange Act of 1934 treat options as conferring the ownership of the underlying security, I will not repeat that analysis. In its last filing, BA-GTE sought to argue, however, that the SEC's rules under Section 13d of that statute did not deem options to confer beneficial ownership. Specifically, they argued that Rule 13d-3 ("Determination of Beneficial Owner") exempts options for purposes of the Williams Act's reporting requirements if the option cannot be exercised within sixty days. BA-GTE's construction of Rule 13d-3 simply misread it, however, because they failed to call the Commission's attention to the "provided, however" language in Rule 13d-3(d)(i), which reads as follows:

> "provided, however, any person who acquires a security or power specified in paragraph (A), (B) or (C) above, <u>with the purpose or effect of changing or influencing control of the issuer</u>, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to be the beneficial owner of the securities which may be acquired through the exercise or conversion of such a security or power."

Because paragraph (A), (B) and (C) expressly cover options and conversion rights, this language unmistakably says that any option or conversion right that has the "purpose" or "effect" of "influencing control" makes the holder the immediate owner of the underlying security. On conversion of its Class B shares, BA-GTE would hold Class C shares representing 96% of the voting power of Genuity (see Genuity Registration Statement, April 7, 2000, at p. 3). I do not believe anyone can assert with a straight face that such voting power does not "influence" control.

II. THE "CONTROL" ISSUE

13. BA-GTE have marginally redesigned the board structure of Genuity and the "Investor Safeguards" but they have not addressed AT&T's fundamental claim that their option confers control over Genuity. Nor do they discuss or acknowledge the unchallenged fact that BA-GTE will have appointed all the officers of Genuity over this critical transitional period while BA-GTE seeks to satisfy Section 271. While this period could last as long as five years (or a sixth year should BA-GTE so request), Genuity's officers will also be aware that the interim period could be much shorter. Realistically, the officers of Genuity have to be aware that unless BA-GTE has terribly misjudged the odds of securing Section 271 compliance (and this Commission has similarly misevaluated them), it is only a relatively short period before BA-GTE will have absolute voting controls over Genuity. In Samuel Johnson's phrase, nothing concentrates the mind like the knowledge that one is to be hanged in a fortnight, and the officers of Genuity are certain to have a similarly "concentrated" thought process over this interval.

14. Not only will Genuity's officers necessarily recognize that their future careers in all likelihood depend on accommodating BA-GTE, but any rational board at Genuity must also recognize that Genuity's business planning must necessarily take account of the high probability that its operations will be re-integrated with those of BA-GTE. It would be simply unrealistic and wasteful for Genuity to develop duplicative departments or lines of business when those duplicative activities or staff would predictably be eliminated at the end of five years (or sooner)

as redundant. Indeed, it would be difficult to staff offices or divisions under such a death sentence. This point is reinforced by the Purchase, Resale and Marketing Agreement (the "Marketing Agreement") between BA-GTE and Genuity which commits Genuity, among other things, to engage in joint marketing with BA-GTE on a state by state basis as individual states are opened to competition (as New York State has already been). The existence of such a future joint marketing commitment simply makes it pointless for Genuity to develop independent marketing plans of its own or to take any steps to implement independent initiatives. Nor would other entities view Genuity as an independent actor with whom they could develop joint plans or arrangements. In short, BA-GTE's looming majority ownership eclipses the nature of the business planning in which Genuity can engage.

15. In this light, it is useful to recall the SEC's long-standing definition of the term "control" in its Rule 405:

> "The term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means the possession, <u>direct</u> <u>or</u> <u>indirect</u>, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." See 17 C.F.R. 230.405 (emphasis added).

Here by virtue of colonizing Genuity with its own employees as its officers, by contract (the Marketing Agreement), and by its voting interest, BA-GTE effectively controls the future key managerial decisions and policies of Genuity.

16. In response to these obvious points about <u>de</u> <u>facto</u> domination, BA-GTE now asserts that Genuity's board will become majority independent. But the truth is that Genuity's board has already been largely "sterilized," as many of the most important decisions normally

facing a public company in Genuity's position have been taken out of its discretion, pursuant to both the Marketing Agreement and the "Investor Safeguards." For example, Genuity's board cannot:

1. consider a merger or sale of all or substantially all its assets, because a Class B vote is required (with the result that both the Genuity board and its Class A shareholders are disenfranchised);

2. authorize additional stock;

3. make any material changes in the nature or scope of Genuity's business;

4. declare any "extraordinary" dividends or distributions;

5. issue shares or share equivalents above fairly low levels (for example, shares may not be issued "to fund operating needs" in an amount in excess of 5% of Genuity's outstanding shares at the time of its IPO);

6. dispose of more than 20% of Genuity's assets;

7. make an acquisition in excess of $100 million (which is only 1% of Genuity's estimated $10 billion market value) or any series of acquisitions in excess of 20% of the fair market value of Genuity's assets; or

8. incur debt in excess of $3.85 billion in any one year (which is 35% of $11 billion) or $11 billion over five years.

Nor can the Genuity board cancel or amend the Marketing Agreement, which contract commits Genuity to become BA-GTE's junior partner in marketing operations for states that have been opened to competition. As a result, Genuity is economically wedded to BA-GTE, with even its marketing operations and business plans placed beyond the reach or control of Genuity's board.

17. Such restrictions are simply not imposed on the boards of independent, public companies, and particularly not at the behest of an allegedly 10% minority shareholder. Boards of public companies in the real world (and particularly in the competitive and volatile universe of

Internet companies) are not conservators or trustees, who must maintain the company statically in the fashion that they inherited it, as if it were a museum to be preserved; rather, such startup companies typically change dynamically and structurally, often at breathtaking speed. Indeed, the inability to change one's business plan more than marginally would seriously constrain most Internet startups and probably render many non-competitive. Almost by definition, independent companies have boards that do extensively change their business plans and scope of operations, that do buy and sell assets above the restrictive levels here specified by BA-GTE, and that do issue shares and borrow significant funds (and indeed often radically change their company's level of leverage). To the extent that Genuity's board is so confined within this web of restrictions, it is "sterilized" in the conventional terminology, and such a sterilized board is the sign of a controlled company.

18. Genuity's board is further enfeebled by the provision in its Certificate of Incorporation to the effect that no Class A shareholder may own more than 20% of the Class A stock. As a fair generalization, research on corporate governance has shown that boards perform better when they are monitored by strong shareholders. But no truly strong shareholder can emerge at Genuity because this provision atomizes the shareholders base of the Class A shares. To be sure, many boards do adopt "poison pills" that impose similar ceilings on the aggregation of shares, but there is a critical difference: the "poison pill" or "shareholder right plan" is essentially a device to compel an outsider to negotiate with the board before attempting to undertake a corporate control contest. Here, the Genuity board cannot negotiate with such an outsider because it cannot release this restriction. Once again, a critical decision area has been taken out of the board's hands by BA-GTE.

19. BA-GTE have sought to defend the straitjacket in which they place the Genuity board as consisting only of normal and reasonable restrictions that any substantial investor in their position would demand. This argument is highly debatable, because the restrictions that BA-GTE point to are normally in force only for the period pending consummation of a merger or acquisition (and not for a multi-year period). Nor are such restrictions ever imposed by a minority shareholder who holds only 10% of the company's equity. More importantly, however, BA-GTE themselves contradict their own position that their safeguards are normal and ordinary by the way they structure their "Investor Safeguards." Although some of their restrictions are given to the holders of the Class B shares, the most restrictive are instead conferred on "Newco" directly. This means that any purchaser of the Class B shares only obtains the ability to veto a merger or the authorization of additional stock or certain amendments to Genuity charter or by-laws, but never acquires the more intrusive ability to block share issuances, extraordinary dividends, the incurrence of debt, any sales or dispositions of assets above specified levels. Frankly, most of the veto power given to the Class B shares (such as the right to block a merger) seen less extraordinary than the more unique powers given to Newco. The point is that if these veto powers were as normal, ordinary and reasonable as BA-GTE maintains, BA-GTE would have given them to any purchaser of its Class B shares. But it has not. Underscoring this contrast is the fact that a purchaser of BA-GTE's Class B shares "could convert those shares only into Class B shares, which do not have enhanced voting rights" (see Barr Letter, Exhibit A at p. 4), while BA-GTE will be able to convert its Class B shares into Class C. Class C's greater rights are thus uniquely conferred on BA-GTE. In short, BA-GTE has far more powers and rights on itself than on any presumptively reasonable third-party to whom it might sell its Class B shares.