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June 5, 2000

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Handwritten signature/initials: MS-184

Re: *GTE Corp. and Bell Atlantic Corp., CC Docket No. 98-194*

Dear Ms. Salas:

On behalf of AT&T Corp. ("AT&T"), this *ex parte* letter addresses two matters relevant to this proceeding. First, it discusses certain disclosures made in the May 24, 2000 S-1 Registration Statement ("May 24 S-1") filed by Genuity Inc. with the Securities Exchange Commission ("SEC") that shed substantial further light on the proposal of Bell Atlantic Corp.'s and GTE Corp. (collectively "Applicants") concerning GTE's interLATA voice and data assets. In addition, this *ex parte* letter responds to Applicants' May 19, 2000 *ex parte* submission. In that submission, Applicants suggest, *inter alia*, that the Hart-Scott-Rodino Antitrust Improvement Act ("HSR Act") provides support for their proposal.

**1. The May 24 S-1.** The federal securities laws required Applicants in their S-1 to disclose to the prospective purchasers of Genuity's Class A shares of stock, among other things, the ways in which those purchasers' traditional rights would be encumbered by the special rights granted Applicants as holders of the Class B shares of stock. At least one highly significant such provision has not previously been revealed in Applicants' filings to the Commission.

Specifically, the S-1 contains a paragraph entitled "Mergers and Other Business Combinations." That paragraph states that, in the event Genuity engages in a merger with another entity, "the holders of the shares of Class B common stock shall be entitled to receive, at their election, either (1) the merger consideration such holders would have received *had they converted their shares of Class B common stock immediately prior to the consummation of such transaction* or (2) a new security that is convertible into the merger consideration and has substantially identical voting and other rights as the Class B common stock." May 24 S-1 at 83 (emphasis added). Thus, if there is a merger involving Genuity – even if that merger occurs

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before Bell Atlantic has obtained interLATA authority for 50% of its access lines – then Verizon would be entitled to consideration for that merger as if it were an 80% common stock holder in Genuity.

This provision is revealing in two respects. First, it further confirms that Applicants would have an “equity interest (or the equivalent thereof)” far in excess of 10%. It is simply impossible seriously to maintain that an entity which will obtain consideration as if it were an 80% stockholder of a firm in the event that firm engages in a merger does not have an equity interest in that firm (or, at the very least, the absolute “equivalent” of an equity interest). It is likewise impossible seriously to maintain that an entity that can cash out in this manner does not possess the right to participate in the firm’s earnings.<sup>1</sup> Indeed, the purpose of this provision is to ensure that, if an event with real economic consequences occurs prior to the point at which Applicants may convert their Class B shares, the pretense that they have only a 9.5% interest will be dropped for purposes of that event. (Applicants elsewhere in the S-1 make sure that the other principal type of event with economic consequences that would vary depending on whether they were viewed as a 9.5% stockholder as opposed to an 80% stockholder – the distribution of earnings through dividends or related mechanisms – simply will not occur. The May 24 S-1 advises Class A shareholders that there will be no ordinary dividends and Applicants have given themselves a veto right over all other ways in which earnings can be distributed. *See* May 24 S-1 at 22, 75-77.)

Second, this feature of Applicants’ proposal vividly illustrates the broader phenomenon that the Commission recognized in the *Fox Television* cases.<sup>2</sup> When – as in *Fox* and as here – one party contributes all of the capital to a new company and determines its capital structure, that party has the ability unilaterally to design and then characterize in any way it wishes the financial interests it takes back in exchange for that contribution. Particularly searching and skeptical scrutiny of such transactions is therefore required. A party in that circumstance can, and usually will, design instruments that bear whatever label an agency may have indicated receives favored status – in this instance, Applicants hope that status will be afforded conversion rights that are contained within voting stock – but then pour into that vehicle all the same ownership, control, and other rights anyone could ever want or need, as Applicants have done here. That is why the Commission in *Fox* examined the rights that the financial instruments in that proceeding provided to their holders and not the labels of those instruments, and why the Commission ultimately found the amount of NewsCorp’s contribution to Fox’s parent entity the most

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<sup>1</sup> *See* Declaration of Professor Ronald Gilson, ¶¶ 16, 18 (Feb. 22, 2000) (claiming that the right to participate in earnings is a fundamental feature of equity).

<sup>2</sup> Second Memorandum Op. and Order, *Application of Fox Television Stations, Inc.*, 11 FCC Rcd. 5714 (1995); Memorandum Op. and Order, *Application of Fox Television Stations, Inc.*, 10 FCC Rcd. 8452 (1995).

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revealing indication of the extent of its actual ownership interest. There is no basis for following a different course in this proceeding.

The liquidation rights described in the S-1 are another manifestation of that same phenomenon.<sup>3</sup> Applicants have given themselves liquidation rights in excess of those enjoyed even by “pure” common stock holders. In a provision of the S-1 entitled “Liquidation,” the S-1 states that Genuity “may not dissolve, liquidate or wind up our affairs without obtaining the consent of the holders of the outstanding shares of our Class B common stock.” May 24 S-1 at 83. Again, this provision makes clear that in the occurrence of an event with real economic consequences, Applicants would not be treated as mere 9.5% shareholders, but would have the right to capture the lion’s share of the value of Genuity. For example, if Genuity entered bankruptcy prior to Applicants’ obtaining long-distance authority for 50% of their lines, Applicants could refuse to permit any liquidation at all until the 50% point was achieved (at which point they would be able to convert their shares and obtain virtually all of the liquidation value of the firm).<sup>4</sup>

These provisions are simply part of the overall design of Applicants’ proposal. Applicants have ensured that all of the economic returns Genuity earns during the period before they “convert” their Class B shares will not be distributed to the putative Class A “owners” but instead will remain in Genuity to be recaptured by Applicants. Thus, while the Class A shareholders initially have 90.5% of the vote, the Class B shares represent at least an 80% equity interest because they ensure Applicants capture 80% of Genuity’s earnings, at least 80% of Genuity’s liquidation value and, through the veto provisions attached to the Class B shares, allow Applicants to cancel out the Class A shareholders’ “vote” on Genuity’s most important corporate decisions, including any decision by the Class A shareholders that would threaten to dissipate Applicants’ majority equity investment.<sup>5</sup>

**2. The HSR Act.** In their *ex parte*, Applicants point to a provision of the rules of the Federal Trade Commission (“FTC”) implementing the HSR Act that they claim supports their contention that options are not equity. In particular, they cite 16 C.F.R. § 802.31, which

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<sup>3</sup> See Response of Bell Atlantic and GTE, at 4 (Feb. 22, 2000) (claiming that liquidation rights are another fundamental feature of equity); Declaration of Professor Ronald Gilson, ¶¶ 16, 18 (Feb. 22, 2000) (same).

<sup>4</sup> Alternatively, they could refuse to permit liquidation at all unless and until the Class A shareholders agree to an unfair and disproportionate distribution of the liquidated value favoring the Class B shares.

<sup>5</sup> The discussion above focuses on particular disclosures in the S-1, and is not meant to be exhaustive. AT&T has identified in its prior filings the many other aspects of Applicants’ proposal that demonstrate that the proposal would violate the Communications Act.

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provides that “[a]cquisition of convertible voting securities shall be exempt from the requirements of the act.” Relying on this provision, they claim that “interest[s] convertible into voting stock do[] not count as the acquisition of cognizable ownership interest for purposes of antitrust review under” the HSR Act. BA-GTE May 19, 2000 *Ex parte*, Att. at 5 (citing 16 C.F.R. § 802.31). The HSR Act principles Applicants seek to invoke, however, weigh strongly against their proposal, for at least three independent reasons.

First, Applicants’ Class B shares are not “convertible voting securities” and therefore are not covered by 16 C.F.R. § 802.31. “Convertible voting securit[ies]” are defined as securities “which presently do[] not entitle [their] owner to vote for directors of any entity.” 16 C.F.R. § 801.1(f)(2). The Class B shareholders, however, would vote for all directors of Genuity and, indeed, elect a director independently. The Class B shares would therefore be “[v]oting securities” because they “entitle the owner or holder thereof to vote for the election of directors of the issuer.” *Id.* § 801.1(f)(1).

Thus, while Applicants in the past have claimed that their Class B shares can for purposes of analysis be decomposed into two separate components, a pure common stock component and an “option,” neither the HSR Act nor the FTC’s rules permit such disaggregation. Rather, as noted, a voting security is defined as any security that permits the holder to vote on director elections and antitrust review is triggered if “the aggregate total of the voting security . . . [is] in excess of \$15,000,000.” HSR Act, § 7A. The aggregate total value of voting securities is generally determined by the market value of the securities as a whole and not its individual “components.” *See generally* 16 C.F.R. § 801.10. And here there can be no doubt that the market value of Applicants’ Class B shares are in excess of \$15 million. Thus, any transaction involving the sale or acquisition of the Class B shares would trigger antitrust review under the HSR Act.

Second, Applicants’ analysis is incomplete because it ignores 16 CFR § 801.90. That provision states that “[a]ny transaction(s) or other device(s) entered into or employed for the purpose of avoiding the obligations of the act shall be disregarded, and the obligations to comply shall be determined by applying the act and these rules to the substance of the transaction.” *Id.* Thus, where it is the case that a purchaser is trying to acquire control of a company but using options to avoid the HSR Act’s notification requirements, the FTC will look to the “substance of the transaction.” Here, as AT&T as explained in its prior filings, Applicants’ proposal is designed to ensure that Genuity would conduct its business in order to advance Applicants’ interests.<sup>6</sup>

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<sup>6</sup> *See generally* Opposition of AT&T Corp. to Applicants’ Revised Proposal Regarding GTE’s InterLATA Operations (May 5, 2000) (“AT&T Rev. Opp.”); AT&T March 22, 2000 *Ex Parte*.

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Finally, even if the Class B shares were “convertible voting securities” and not “voting securities,” and even if 16 CFR § 801.90 did not exist, acquisition of the Class B shares would still trigger HSR Act review. That is because Applicants would be said to “hold” the underlying stock they would obtain by exercising their conversion right, and therefore even acquisitions involving only the “option component” of the Class B shares would trigger review under the HSR Act. For purposes of determining whether the HSR Act notification threshold is triggered, the FTC looks not at just the securities to which a company has acquired legal title, but at all the securities it would “hold.” 16 C.F.R. § 801.1(c) in turn defines “hold” as including “beneficial ownership.”

The FTC has found that “beneficial ownership” as used in the HSR Act “overlaps with, but is not identical to” the definition of that term adopted by the SEC. *See* 43 FR 33450 (July 31, 1978). The FTC will look at a number of factors in determining beneficial ownership, including the presence of a right to share in increases or losses of value and the right to direct the disposition of the underlying shares. *Id.* AT&T has already explained in detail why Applicants would be the “beneficial owner” of the underlying securities under the SEC’s rules (and that showing is unrebutted).<sup>7</sup> Even if the FTC were to depart significantly from that standard, Applicants would still be a beneficial owner of the underlying shares here because, as AT&T has explained, Applicants would directly share in increases or losses of value of Genuity and Applicants have the right to effectively direct the disposition of the underlying shares.<sup>8</sup>

In this regard, the FTC has made clear that it will find beneficial ownership where an entity is seeking to evade the HSR Act through use of “options” when the transfer of beneficial ownership of the underlying shares has effectively occurred. Indeed, at the FTC’s behest, the Department of Justice has brought numerous enforcement cases imposing substantial penalties against parties that have sought to avoid the HSR Act’s requirements by acquiring options to acquire substantial interests in companies. *See United States v. Trump*, No. 88-0929 (D.D.C. Apr. 11, 1988); *United States v. First City Financial Corp. Ltd.*, No. 88-0895 (D.D.C. Apr. 11, 1988); *United States v. Wickes Co. Inc.*, No. 88-0782 (D.D.C. Apr. 11, 1988). Thus, the FTC,

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<sup>7</sup> Third Declaration of John C. Coffee, ¶ 12 (May 5, 2000); Transcript of April 7, 2000 Debate at 108-12.

<sup>8</sup> AT&T Rev. Opp. at 15-16, 23-25; Declaration of Dr. Richard Clarke, ¶¶ 1-11 (May 5, 2000); Transcript of April 7, 2000 Debate at 108-12; Opposition of AT&T Corp. to Applicants’ Proposal Regarding GTE’s InterLATA Operations, at 9-11 (Feb. 15, 2000).

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for purposes of the HSR Act, has found a party holding an option can "own" the underlying stock even when the party had no right to vote the underlying stock and no right to current dividends.

Yours truly,

  
Peter D. Keisler

cc: Dorothy Attwood  
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