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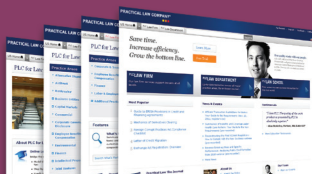

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M&A IN MEDIA AND TELECOMMUNICATIONS

Key Issues and Considerations

The media and telecommunications industries are constantly evolving as market participants attempt to predict whether the traditional distinctions between content providers, distributors and advertisers will remain intact. This uncertainty creates fertile ground for M&A transactions.

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M&A activity in the media and telecommunications industries remains a significant part of the overall US M&A environment. Long-term strategic acquisition decisions once focused primarily on the choices between broadcast television and cable television, content companies and distribution companies or fixed-line telephony and wireless telephony. Now those trends in dealmaking overlap with short-term trends that have arisen out of the growth of the internet and social media. The result is a broadened field of acquisition targets in the media and telecommunications space.

The media and telecommunications industries are in a state of constant motion, as market participants respond to uncertainties in the business and attempt to predict whether the dominant position in the marketplace will be held by:

- Content companies.
- Distribution companies.
- Advertising companies.

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However, a threshold question is whether the historical distinctions among content providers, distributors and advertisers will be maintained and remain relevant for years to come. This uncertainty creates fertile ground for M&A activity. Many market participants are pursuing M&A transactions with the objective being either to:

- Hedge their bets by expanding the range of their market offerings, thereby reducing overall downside risk if market developments weaken one aspect of their business.
- Strengthen their market offerings without increasing diversification, thereby improving performance whether or not there is a broader market shift.

M&A transactions in the media and telecommunications industries present many industry-specific issues. Practitioners need to understand both the commercial imperatives driving their clients and other M&A market participants, as well as the regulatory framework under which companies in these industries operate.

This article identifies key issues and considerations for M&A transactions in the media and telecommunications industries, including:

- Obtaining the required governmental and third-party approvals and consents.
- Key areas for due diligence.
- Issues related to negotiating and drafting the acquisition agreement.
- Questions to consider about social issues.

APPROVALS AND CONSENTS

GOVERNMENTAL APPROVALS

Given the breadth of the media and telecommunications industries, it is not surprising that a panoply of government agencies regulate various aspects of these industries in the US. In evaluating the complexity of the regulatory scheme applicable to a transaction, practitioners need to analyze:

- The governmental approvals that are required to complete a transaction, if any.
- The level and nature of scrutiny that the transaction is likely to receive from governmental agencies.
- The time it may take to obtain the necessary governmental approvals.

This analysis depends on, among other things:

- The governmental entities that have authority over the operations of the target.
- The structure of the transaction.

Companies operating in the media and telecommunications industries may be subject to regulation at the following levels:

- **Federal.** The Federal Communications Commission (FCC) has substantial regulatory authority over distributors of content within the various sectors of the media and telecommunications industries. The current framework for FCC regulation was established by the Telecommunications Act of 1996 (1996 Act), which substantially amended the Communications Act of 1934. The 1996 Act represented a substantial revision of the scope and nature of the regulation of the telecommunications industry in the US. As a result, the FCC now:
  - effectively has sole US regulatory authority over long-distance fixed-line telephony, wireless telephony, the internet backbone, wireless spectrum and broadcast television; and
  - has shared US regulatory authority over local fixed-line telephony and cable television service providers.

  As a general matter, however, the FCC does not have significant regulatory jurisdiction over content companies and the online environment.
- **State.** State public utility commissions (PUCs) continue to have jurisdiction over fixed-line telephony companies that deliver local telephone service through the "last mile" of wires into homes, whether those wires are traditional telephone lines or cable television lines. Under the 1996 Act, the regulatory jurisdiction of state PUCs is, as a practical matter, shared with the FCC. The PUCs tend to focus their regulatory scrutiny on local service issues and the FCC tends to focus on implications for national telecommunications markets and policy.
- **Local.** The US cable industry remains regulated at a local franchising authority (LFA) level, primarily as a result of its historical development. In some states, the LFA is itself a state body or the state PUC. In most areas, however, the LFA is a local, city or municipal agency. Under the 1996 Act and the federal Cable Television Consumer Protection and Competition Act of 1992, the regulatory relationship between the LFA and the FCC with respect to cable service is similar to that of the PUCs and the FCC over local telephony.

Agency Review

If the target in a proposed M&A transaction is subject to regulation of its normal day-to-day operations by any government agency, it must be determined whether that agency must consent to the proposed transaction. This analysis needs to occur on an agency-by-agency basis, taking into account:

- The agency's relevant rules.
- The specific entity within the target that holds the requisite operating license.

As a general matter, structuring a transaction to avoid substantive FCC or PUC review of a change of control transaction is usually of limited value. However, the LFAs (particularly if they are local or municipal) have their own rules and interpretations, which vary substantially.

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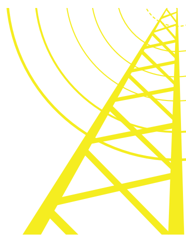

The combination of substantive antitrust review by the DOJ or the FTC, on the one hand, and other industry-focused governmental review, on the other hand, is one of the most complex issues for M&A transactions in the media and telecommunications industries.

If the approval of the FCC, a PUC or an LFA is required to complete the proposed transaction, a number of questions should be addressed by specialist legal counsel, such as:

- **What is the agency's standard of review?** In addition to the strict legal standard for approval under the relevant statute, such as "public benefit" or "net benefit to consumers," counsel must ascertain whether the regulatory agency is likely to impose conditions or otherwise take steps to address its concerns with the target's operations that are unrelated to the transaction.
- **Will consumers or other third parties complain about service, rates or other matters in connection with the agency's review of the transaction?** There is always some risk that an M&A transaction will serve as a lightning rod for consumer complaints. The parties usually share a common concern about whether or not the relevant agency will review the transaction independently of the third-party objections.
- **How do these issues and concerns relate to the overall strategic rationale for the transaction?** Is there risk that the regulatory agencies will seek financial benefits to consumers that will capture a significant portion of the synergies that may be realized in the transaction? Alternatively, is there a possibility that conditions imposed by regulators to resolve concerns might substantially impair the business rationale for the transaction?

Balancing Antitrust Review

In addition to the review of the transaction by industry regulators, there is also the possibility of substantive antitrust review by either the Department of Justice (DOJ) or the Federal Trade Commission (FTC). The combination of substantive antitrust review by the DOJ or the FTC, on the one hand, and other industry-focused governmental review, on the other hand, is one of the most complex issues for M&A transactions in the media and telecommunications industries. For example, because of the different orientation of the various regulators, a transaction may raise significant antitrust issues but may not otherwise be considered problematic, or potentially even desirable, by the FCC. There may also be cases where a transaction raises serious issues for the FCC, but the antitrust issues are more manageable.

For an M&A transaction involving different antitrust and FCC issues, proper coordination of the review processes is very important. This has at least three components:

- **Timing.** Should the parties seek:
  - the more difficult approval first to avoid having the easier approval delayed by concerns about a lengthy regulatory review process with the other agencies;
  - the easier approval first in an effort to apply greater pressure to the agency that is more likely to oppose the transaction; or
  - both approvals simultaneously?
- **Substance.** Will the parties be making similar, different or potentially inconsistent arguments to various regulators?
- **Remedies.** Will the regulators be comfortable with a single set of remedial concerns, or will the various concerns compel different remedies? How should the remedies be negotiated?

>> For an overview of the antitrust-related reporting requirements that apply to certain M&A transactions under the Hart-Scott-Rodino Act, search Hart-Scott-Rodino Act: Overview on our website.

THIRD-PARTY CONSENTS

The type and number of necessary third-party consents should be considered during the structuring stage of the transaction. While as a general matter third-party consents may be triggered in M&A transactions in the media and telecommunications industries in a manner similar to other industries, the most important concerns in these industries usually involve the supply of content by third parties to the target.

Counsel, along with the business team, must analyze whether the proposed transaction will jeopardize the supply of content once the transaction closes. An actual or deemed assignment of an inbound content license by the target to the acquiror could put access to the content at risk if the assignment requires consent. In addition, if the transaction involves a change of control, other consent rights may be implicated. The analysis will depend on, among other things:

- **Contract terms.** The terms of the various contracts by which the third-party content is provided to the target

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will govern if they are explicit on the subject. The result may also differ depending on the governing law of the relevant contract.

- **The proposed structure of the transaction.** Some transaction structures clearly involve an assignment or a change of control while other structures may or may not be deemed to cause an assignment or a change of control depending on the particular circumstances. Questions to review include whether the structure involves:
  - the transfer of the contractual right to receive the content (such as in an asset sale);
  - a merger (whether forward or reverse) involving the entity that has the contractual right to receive the content;
  - a transfer of shares of the target (such as in a stock sale); or
  - the transfer of indirect ownership of the target by a parent within its corporate chain.

  The US case law on this issue is not as consistent as one would like or as many practitioners assume. Many practitioners believe that a change of control transaction, for example a reverse triangular merger, never violates an anti-assignment provision. However, this belief is not well-founded. There is ample precedent for content owners challenging mergers or other change of control transactions.
- **The legal nature of the relevant content license.** The default rules for assignability of copyright and other intellectual property licenses concerning federal intellectual property rights are different than most other contracts. Generally, a licensee cannot assign its rights unless the license agreement expressly allows assignment. Therefore, in addition to obtaining consents for licenses that expressly prohibit assignment, consents may be needed where the license is silent or the contract language is ambiguous. Content licenses typically concern copyright but may also include licenses to other types of intellectual property, including patents. There is a policy of strict interpretation of anti-assignment provisions in favor of the license grantor, particularly if the license is non-exclusive.

>> For more information on the assignability of intellectual property licenses, search IP Licenses: Restrictions on Assignment and Change of Control on our website.

DUE DILIGENCE

The due diligence review of a target operating in the media and telecommunications industries shares many similar features with the due diligence review of companies in other industries. There are, however, a number of areas that are of particular importance for the media and telecommunications industries. As discussed above, anti-assignment or change of control provisions in third-party content agreements are often an important part of due diligence. In addition, issues frequently arise relating to:

- Intellectual property rights.
- Privacy and data security regulation.
- Other regulatory matters.
- Material contracts.

The results of legal due diligence in these areas may have a significant effect on the target's valuation, the structure of the transaction and closing certainty. It is also important that the acquiror appropriately address the outcome of this due diligence in the terms of the definitive acquisition agreement.

>> For more information about due diligence in M&A transactions, search Due Diligence for Public Mergers and Acquisitions and Due Diligence for Private Mergers and Acquisitions on our website.

INTELLECTUAL PROPERTY RIGHTS

Intellectual property due diligence, interpreted broadly, may be fundamental to many acquisitions in the media and telecommunications industries. Depending on the business model of the target, intellectual property-related issues can include the following:

- **Ownership of intellectual property.** Does the target have suitable rights to the content it is currently exploiting? This is a central question in the valuation of any target that is in the business of taking content from third parties and exploiting it for profit. The legal issues differ depending on the nature of the target's business. For example, acquiring a small movie studio raises very different issues than acquiring a cable-delivered movie channel or a website that relies on user-generated content. The due diligence must be tailored to reflect the business model of the target and utilize, where appropriate, a combination of specific "chain of title" due diligence of identified principal rights plus a review of sample agreements by which the target acquires its content. For certain content businesses, a key question may concern the duration of their material intellectual property rights, particularly copyright. For example, under US copyright law, copyright owners may terminate assignments and licenses of their content after a certain period and recapture those rights.
- **Gaps in rights.** Does the target need additional rights that it is not currently getting in order to permit future growth? In the media industry, there are numerous examples of companies whose practices of acquiring intellectual property were inadequate as new sources and methods of distribution became available. To address this concern it is crucial for an acquiror to:
  - understand the business practices of the target;
  - learn about the contracting practices followed by the target; and

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- analyze the target's practices in light of current market conditions and potential growth opportunities.

- **Infringement.** How does the target protect itself from disputes between competing claimants to content ownership or claims of third-party infringement? The violation of intellectual property rights is a frequent occurrence, and no acquiror should expect a target to be immune from infringement claims. An acquiror should understand through the due diligence process how the target protects itself from the consequences of claims of infringement. For example, some companies protect themselves by securing indemnification rights against the providers of content when infringement occurs. This works well if the content provider is itself a significant financial entity. However, this method is not particularly useful if the business model relies on user-generated content that is reproduced on a website. Other companies may rely on statutory protections under the Digital Millennium Copyright Act against liability for innocent copyright infringement so long as they "take down" the infringing work after notice of infringement. The due diligence exercise must determine how the target believes it is protected and whether it actually implements suitable policies and procedures.
- **Worst case scenario.** What is the realistic worst case intellectual property compliance scenario? It is easy to be overly cautious in conducting intellectual property due diligence on media and telecommunications companies, but being overly pessimistic is just as much an error as being too optimistic. It is important, however, through the due diligence process, for an acquiror to establish a view on a realistic worst case scenario for a target that has some level of intellectual property complexity. Investors have committed substantial amounts of money to start-up companies only to find that fundamental issues of intellectual property ownership have invalidated the target's entire business model.

There is also an institutional dimension to attitudes toward intellectual property issues. Historically, content-creation companies have differed from distribution companies in their overall approach to this subject. As companies diversify and as business models (particularly online) converge, there is greater scope for cultural disagreement over the proper treatment of intellectual property.

>> For a checklist of issues to consider when conducting intellectual property due diligence, search IP Due Diligence Issues in M&A Transactions Checklist on our website.

PRIVACY AND DATA SECURITY REGULATION

An issue of growing importance is the application of privacy and data security laws to media and telecommunications companies, particularly as they seek to exploit online business opportunities. This raises at least two distinct issues from a due diligence perspective.

The first issue concerns the target's compliance with applicable privacy and data security laws. This requires an understanding of:

- What types of personal information the target collects and retains.
- How the target collects personal information.
- Where and from whom the target collects personal information (which is increasingly difficult to determine in the online environment).
- How the target uses or monetizes personal information.
- The procedures the target has in place to disclose its privacy practices and receive necessary consents.

A related question involves the availability of online content to minors. In addition to increased scrutiny concerning the collection of personal information from minors, issues also exist concerning the distribution of age-appropriate content and the legal effectiveness of standard "click-through" consent mechanisms.

The second issue requires a determination of the extent to which anticipated changes in the target's business model and the regulation of personal information are likely to curtail the business opportunities available to the target. Due diligence on this topic is not strictly limited to legal matters but also involves a judgment on the:

- Expected developments in the target's business model. Particular attention must be paid to developments involving a greater collection of personal information, a greater use by the target of personal information and the sale or distribution to third parties of personal information.
- Synergistic opportunities anticipated by the acquiror. The most common example of this issue is the contemplated use by the acquiror in its business of personal information collected by the target.
- Potential regulatory developments in relevant jurisdictions.

OTHER REGULATORY MATTERS

The media and telecommunications industries are two of the more heavily regulated industries in the US. Regulatory due diligence has two primary objectives:

- **Confirm the absence of contingent liabilities.** It is imperative for the acquiror to confirm that the target has not committed any material regulatory violations that could result in a significant financial penalty or other meaningful remedy on the target in the future. This will usually involve review of internal records, discussions with target management and possibly outside counsel and review of records of agency proceedings. In high profile

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instances, the acquiror and the target may commission an independent legal review of compliance questions.

- **Confirm that regulatory compliance does not encumber business.** This aspect of regulatory due diligence relates to the viability of the target's business model in light of applicable laws. The acquiror must confirm that it will not be required to make substantial changes to the target's business to bring it into compliance with relevant laws.

A company's approach to regulatory matters must also be considered. An acquiror may have a particular approach to regulatory compliance, or may be subject to commitments in favor of regulators that go above and beyond strict compliance with the law. Due diligence on the target's regulatory compliance profile must go beyond the narrow question of general compliance. To be meaningful, it must explore whether including the target in the acquiror's overall regulatory profile creates significant negative synergies.

MATERIAL CONTRACTS

As in any significant acquisition, investigating material contracts is a key aspect of due diligence. In the media and telecommunications industry, however, this investigation is likely to be of particular importance in transactions other than those involving the largest companies in the industry. Depending on the target, material contracts may relate to a number of matters, including:

- Use of talent.
- Acquisition of content.
- Distribution of content.
- Provision of technical services.
- Use of physical facilities.

The media and telecommunications industries tend to raise concerns related to:

- **Required consents.** The acquiror should identify material contracts that have consent rights and, if necessary, condition the transaction on receipt of the necessary material consents.
- **Duration of term.** Many material contracts may be for a fixed term. The acquiror should be aware of key contracts that are of limited duration and consider the potential impact of the transaction on the acquiror's ability to renegotiate or extend those contracts on favorable terms.
- **Provisions impacting the acquiror's business.** Many contracts may have most favored nations provisions or other terms that potentially could be implicated by the transaction. Poorly-drafted exclusivity or non-compete provisions may also adversely affect the acquiror's business, the opportunities for synergistic growth of the target following the transaction or the target's selection of future acquisition transactions.

Another significant issue that frequently arises in connection with due diligence of material contracts is antitrust sensitivity and the use of "clean teams." If the transaction raises antitrust issues, the parties may be unwilling or unable to permit full access to material contracts. Potential solutions include:

- Restricting access to material contracts to a specified group of the acquiror's personnel who are not involved in sensitive pricing decisions (a clean team) or to outside counsel.
- Retaining an outside expert to review the sensitive contracts and provide summaries on a blind or aggregated basis.
- Permitting access only at the very last minute.

NEGOTIATING AND DRAFTING THE AGREEMENT

Negotiating and drafting a definitive agreement for an M&A transaction in the media and telecommunications industries raises many of the same issues as in other industries. However, two issues of particular importance are the regulatory efforts covenant and the exceptions to the material adverse change (MAC) standard.

REGULATORY EFFORTS

Given of the complex regulatory framework, it is not surprising that the media and telecommunications industries have seen some of the largest transaction failures arising out of regulatory scrutiny. Whether representing an acquiror or a target, negotiating the overall "regulatory efforts" package involves a number of considerations, in particular:

- **A recognition that all regulatory aspects of the agreement are interrelated.** This includes the "efforts" covenant itself, the outside (or drop-dead) date for closing, the precise wording of the closing conditions and any regulatory break-up fee.
- **A precise understanding of the expected regulatory hurdles and their solutions, if any.** In this aspect of the process, counsel must be both realistic and pessimistic. The client must be informed of the expected outcome and also of the realistic worst-case scenario. In markets as dynamic as media and telecommunications, counsel must also anticipate whether the transaction may stimulate a shift in traditional regulatory analysis. In the antitrust area, for example, issues of barriers to entry and market definition are seldom static. Transactions that were unthinkable a decade ago may now pass scrutiny, while remedies that might have been sufficient in the past will no longer address all of the regulatory concerns.
- **A business negotiation as to the level of commitment (and associated loss of value) the acquiror will commit to accept.** If counsel has identified a range of potential regulatory outcomes, the

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acquiror must determine where in the range of those outcomes it will draw the line and determine not to proceed. Equally, the target must consider the level of closing risk created by the same range of outcomes and how it weighs that risk against the benefits of the transaction.

- **The optimal contract drafting to reflect the agreed level of commitment.** This may be incorporated into the efforts covenant, the closing conditions or both.

One issue that is increasingly being negotiated is the effect of any reverse break-up fee on the acquiror. Perhaps because of confusion arising out of the use of reverse break-up fees as liquidated damages in private equity transactions, inexperienced counsel sometimes fails to draw the distinction between the efforts covenant, which presumably will be enforceable in the event of breach through customary legal and equitable remedies, and the reverse break-up fee, which normally will be payable to the target if it properly asserts a failed condition or a valid termination right under the agreement.

>> For more information on reverse break-up fees, search Reverse Break-up Fees and Specific Performance on our website.

MAC CLAUSES

As in other industries, M&A transactions involving media and telecommunications companies will usually include the use and negotiation of MAC clauses, including the litany of standard exceptions to those clauses. Two distinct issues that arise when negotiating MAC clauses include the usual exceptions from the MAC definition for:

- **"Changes in law, including interpretations thereof."** Given the importance of the regulatory framework for the media and telecommunications industries, an acquiror must be careful before agreeing to what might otherwise be seen as a standard MAC exception. It is also important for the language in the "changes in law" exception to the MAC clause to be coordinated with the regulatory efforts covenant if that covenant is linked to an "absence of MAC" standard. The concept is fairly straightforward, even if the drafting may be challenging. The acquiror must consider whether it is permitted to take into account adverse effects from changes in interpretations of law by the regulatory agency itself for the purpose of determining the amount of adverse effect from the regulatory process it must bear before it is excused from closing.
- **"Changes arising out of the transaction."** The acquiror must consider the potential impact of the transaction on talent, employees and business counterparties of the target as this exception is being negotiated. Again, it is surprising how frequently an acquiror will mishandle the negotiation and drafting of the definitive agreement on this key point, usually by overlooking that a MAC qualification plus the customary "changes arising out of the transaction" exception can substantially limit the usefulness to an acquiror of representations, warranties, covenants and closing conditions that relate to impacts of the transaction on the business.

SOCIAL ISSUES

All M&A transactions have the potential to raise social issues. Acquirors are often faced with the question of how to retain and motivate the target's human talent, whether it be movie executives, game designers or website engineers. The media and telecommunications industries tend to raise the following special issues:

- **Keeping personal relationships intact.** This issue is particularly important with respect to talent (for example, actors, directors, writers and performers). It may be essential for an acquiror to retain many of the target's employees in order to keep those relationships.
- **Maintaining company culture.** Many talented employees may have made a conscious decision not to "go corporate" and may be disturbed by finding themselves part of a much bigger organization. Soft commitments about culture, including retention of senior executives and business locations, may be important in retaining key employees.
- **Incentivizing key employees.** Although the acquisition may make executives and key employees very wealthy, non-compete clauses only go so far in motivating people to keep working. Incentives such as deferred payouts, substantial continuing equity involvement and other contingent or delayed consideration may be appropriate to retain and incentivize key employees.

PRACTICAL CONSIDERATIONS

The dynamic market environment and complex legal framework for M&A transactions in the media and telecommunications sectors make the traditional legal roles of structuring, negotiating and drafting transactions particularly challenging. Counsel must draw on their usual skills, but complement them with specialist advice and experience to deliver the best product to the client.

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