Private Equity Role in Media Buyouts Enhances Importance of FCC Ownership Issues at Fund Formation

For a variety of reasons, 2006 proved to be a record year for private equity. According to a recent *Economist* report, the value of US LBO transactions increased by roughly $100 billion last year. Nowhere was this development more prevalent than in the media sector, with proposals to acquire Univision, Clear Channel, the New York Times television group and a number of other broadcast properties. This trend shows no sign of abating. Indeed, one private equity firm recently announced that it had raised $12 billion for its latest fund for media and other communications investments.

Because investors in private equity and hedge funds may hold (or later acquire)—directly or indirectly through participation in other funds—other media investments in addition to their interests in these funds, fund managers contemplating positions in US media companies (or wanting the flexibility of taking such positions in the future) need to focus on the restrictions imposed by the Federal Communications Commission (FCC) on cross-ownership of media companies. Given the difficulty of amending a fund's organizational documents later, fund formation is the ideal point at which to address the effects of these restrictions. Drafting these documents with reference to the FCC's restrictions also makes it easier to address FCC concerns about the character qualifications and foreign ownership of media investors.

Cross-Ownership Restrictions

The FCC's principal media cross-ownership restrictions are (1) the television "duopoly" rule (which applies to interests in more than one television station within the same market), (2) a cap on the number of radio stations owned in the same market, (3) limits on ownership of television, radio and/or newspaper outlets in the same market, and (4) a cap on the number of television households served nationwide. In applying these rules, the FCC looks at the media interests of all "attributable" investors in a media company. The application of these "attribution" rules to interests in corporations is relatively simple. Generally, they apply only to holders of 5% or greater voting interests, or to officer or director positions. But the FCC's rules also require an analysis of the media ownership interests held by upstream investors in those who hold attributable interests in media companies. For investors organized as limited partnerships or limited liability companies (as most private equity and hedge funds are), this analysis can become very complex.

In particular, the FCC presumes every limited partner in a limited partnership, and every member of a limited liability company (LLC), to "own" a media investment held by the partnership or LLC unless that limited partner or member is "insulated" from any ability to influence the management or operation of the relevant media entity in the very specific terms set forth below. If a private equity fund holds an attributable interest in a broadcast licensee, the failure to include these specific terms in the fund's organizational documents could preclude or substantially delay FCC action on pending sale applications unless and until the buyer can demonstrate the absence of any conflicting media interests by each of the investors in the fund. Failing to insulate investors in this way can also implicate the buyer's ability to make the usually required representations, warranties and covenants concerning its compliance with regulatory requirements, and pose difficulties for future media investments by the investors or the fund. Moreover, if the FCC discovers a violation of its multiple ownership rules, it can require divestiture—as it did in the case of the Gabelli Funds in 1992—or impose other sanctions.

Provisions Restricting Rights of Exempted Investors

To ensure that a limited partner or LLC member is exempt from ownership attribution in the fund (and thus that the investor's other media interests would be irrelevant), the partnership or LLC agreement must contain seven provisions restricting the rights of such an exempted investor. Where the investment is in a fund that in turn is an investor in a media entity, these provisions should apply not only to the fund, but also to the media entity itself:

- No such investor may act as an employee of the fund or media entity if his or her functions, directly or indirectly, relate to its media enterprises.
- No such investor can serve, in any material capacity, as an independent contractor or agent with respect to the fund or media entity's media enterprises.
- Such investor may not communicate with the fund or media entity (or the general partner or managing member, as the case may be) on matters pertaining to the day-to-day operations of the media business.
- The general partner (or managing member) must be empowered to veto the admission of any additional general partner (or member) who can be admitted by vote of the investors.
- No such investor may vote on the removal of a general partner (or managing member), or the right must be limited to situations where the general partner (or managing member) is subject to bankruptcy proceedings, adjudicated incompetent or removed for cause as determined by an independent third party.
- No such investor may perform any services for the fund or media entity materially relating to its media activities, with the exception of making loans to, or acting as a surety for, the business.
- No such investor may become actively involved in the management or operation of the media businesses of the fund or media entity.

Limits on Foreign Ownership

The Communications Act of 1934 still imposes a 25% limit on aggregate foreign ownership in broadcast licensees, even where held indirectly in a parent corporation. (The limit applies only to present stock, partnership or LLC interests, and not to bona fide warrants, options or convertible debt.) Thus, as a threshold matter, managers of funds contemplating present or future investments in media entities must be in a position to monitor the extent of foreign ownership in their funds on a regular basis. This task is made more challenging by the FCC's requirement that the fund manager look through investments held by US legal entities to their ultimate owners, and by the agency's interpretation of the Act to require separate calculations of both voting and equity interests for purposes of ensuring compliance with the 25% limit. For this reason, the fund's organizational documents should require each new investor to disclose the extent of its foreign ownership (as calculated by the FCC), report to the fund manager periodically any changes in that information, and permit the fund manager to take any actions reasonably necessary to maintain compliance with the FCC's ownership restrictions.

Moreover, the FCC's way of calculating compliance with the 25% aggregate foreign ownership limit depends, like its media cross-ownership rules, on whether the fund has in place the seven insulating provisions set forth above. Although the FCC's decisions on this point are not entirely consistent, the agency has considered a foreign limited partner or LLC member to own a fund's entire interest in a broadcaster unless the foreign investor's opportunity to influence the management of the media enterprise is insulated through these seven provisions.

An example shows how draconian the FCC's rule can be. Assume that a fund is contemplating a 40% investment in a US broadcast holding company, only 5% of the shares of which are currently foreign-owned. Assume further that the fund itself is only 10% foreign-owned. If foreign investors in the fund are insulated through inclusion of the seven provisions in the fund's organizational documents, the FCC will consider the fund to be increasing the broadcaster's aggregate foreign ownership only from 5% to 9% (i.e., by 10% of 40%, or 4%, more). Without the insulation provisions, the FCC would prohibit the fund's contemplated investment as well in excess of the statutory 25% limit, because it would treat the entire 40% investment as completely foreign owned.

Conclusion

In forming a private equity fund or other limited partnership or LLC that may be investing in US broadcast entities, it is critical to insert the FCC's insulating provisions in the fund's organizational documents. It is

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also important for fund managers to ensure that they have (and later continue to have) reliable information as to the extent of foreign ownership in their funds, and to provide themselves with adequate authority to ensure continued compliance with the FCC's ownership restrictions and other rules.

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