Acquiring a telecommunications company? Key issues to consider in due diligence

Robert Bratby and Stephanie Liston, Wilmer Cutler Pickering Hale and Dorr

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Investors are showing increasing interest in companies operating in the telecommunications market, and with good reason. The long-expected consolidation of traditional telecoms companies is beginning with the Cingular-AT&T Wireless and Sprint-Nextel mergers, acquisitions of Radianz, Infonet and Bulldog, new investment in Intelsat and Inmarsat, and talk of further activity involving US long-distance operators. Investment also continues in new, disruptive technologies such as Voice over Internet Protocol (VoIP), various forms of wireless connectivity (such as the wi-fi (local area), wi-max (last mile) IEEE 802.11 x and IEEE 802.16 families of technologies) and in companies operating in the mobile sector, especially those providing value-added, and content, services and applications.

As a result of the requirements of the Sarbanes-Oxley legislation in the US (*see below, Accounts and Sarbanes-Oxley*) and increased investor scrutiny elsewhere, public companies are distributing more reliable and transparent accounting and reporting information. Although a significant comfort to investors, it is no substitute for thorough commercial and legal due diligence of an investment target in the telecoms sector. In any industry, that investigation provides information essential to decide whether, at what price and on what terms to acquire or invest. Investing in a telecoms operator requires not only a review of the target's compliance with regulatory obligations and prohibitions, but also an understanding of its primary revenue streams, costs and accounting. Investing in equipment and software manufacturers requires, among other things, a sophisticated analysis of intellectual property rights.

Investing in the telecoms sector can be risky. Properly executed commercial, legal and accounting due diligence improves the investor's prospects of making the right investment decision, for the right price and on appropriate terms.

This chapter addresses:

- The due diligence issues that may apply to an investment in any telecoms service provider or operator.
- Some of the specific concerns that apply to each of four distinct categories of service providers: fixed, mobile, internet and cable.
- Factors of particular importance when the target company is a manufacturer of telecommunications equipment and software.

(This chapter generally refers to a prospective acquiror of a stake in a telecoms company as an "investor", but where an investment would result in a change of control, we use the term "buyer".)

TARGET: TELECOMS SERVICE PROVIDER

When considering an investment in, or an acquisition of, a telecom service provider, there are specific areas on which due diligence should focus.

Licences

A prospective investor in a telecoms service provider usually wants to determine early on whether the target company holds all necessary licences. (This chapter refers to all authorisations, including franchises, as licences.) Licensing requirements may vary substantially among countries, local jurisdictions and technology platforms. The investor should therefore require the target to identify and provide copies of all permits, licences, approvals and other authorisations issued by any domestic or foreign governmental authority. The information provided should include the nature of the authorisation, the applicable jurisdiction, the expiration date and any material conditions attached to the authorisation. Although in the EU many rules are, in theory, harmonised, in practice, there remain significant differences among member states. Therefore, due diligence must be performed country by country or, in the US, state by state, as necessary.

Any gap in licences required to operate a network is obviously important. Representations and warranties may not provide adequate protection. In the US, a deal transferring control of a telecoms company generally cannot close unless and until the relevant regulatory agencies (both the Federal Communications Commission (FCC) and state public utility commissions) have consented to the transfer of licences. If the seller has represented and warranted that it has all necessary licences, the buyer can pursue its contractual remedies (including rescission) to the extent that they are included in the purchase and sale contract. However, any damages awarded may not be adequate, and the buyer's best course, therefore, is to require, as a condition of closing, that the relevant regulators have approved the transfer of all licences.

If the target holds all relevant licences, it still may require government approval to transfer those licences to the buyer. Rules restricting foreign ownership of telecoms companies may limit transferability. Even where foreign ownership restrictions do not appear to apply to the proposed transfer, such as where both the buyer and seller are based in nations belonging to the World Trade Organisation (WTO), acquisitions may still be blocked for political or national security reasons. For example, in the US the FCC will not approve a transfer of control if the executive branch expresses national security concerns about the contemplated deal. In addition, on the recommendation of the Committee on Foreign Investment in

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the US, the President can block any foreign entity's acquisition of control of any US entity, as occurred with Hutchison Whampoa's bid (with SingTel) to acquire the assets of Global Crossing. Similar national security concerns arise in European acquisitions, where transactions involving incumbents raise difficult political issues due to the large numbers of workers employed by incumbents and the strength of unions.

Restrictions on foreign ownership may require identification of the ultimate owners of both the investor and the target, to permit the regulator to assess whether the investment will result in too great a share of overall foreign ownership, of non-WTO ownership or of ownership by entities from particular nations. This inquiry can be laborious, time-consuming and sometimes fruitless as a result of complex or opaque partnership holdings, the owners' preference for privacy or the suspicions of the regulator. Due diligence efforts in this area cannot begin too early in the process.

Finally, regulators may impose conditions that must be met in order for the transfer to be authorised. For example, the competition authorities in Germany would not permit Liberty Media to acquire control of the cable TV assets of Deutsche Telekom unless Liberty Media agreed to upgrade those facilities to make them telephone-capable within a specified time. In the US, state regulators routinely condition their approvals on licencees' agreeing to build out their networks (for example, to provide a digital subscriber line (DSL) in underserved areas), reduce their retail rates or take other steps. The FCC conditioned the entry of some Regional Bell Operating Companies into long distance markets on those companies' agreement to launch competitive entry into each others' territories. Due diligence provides the basis for understanding the hurdles and costs that would be involved as a result of these conditions.

Regulatory compliance

In addition to confirming the issue and transferability of all relevant licences, an investor should review pending complaints or investigations that might either jeopardise the target's licences or otherwise subject it to substantial liability. To this end, the target should be required to provide copies of any formal or informal petitions, requests or complaints (whether granted, denied or not acted upon) submitted to any government authority that seek, or could result in, the modification or revocation of any of the target's (or investor's) licences, or that could otherwise have a material adverse effect on the business of the target or its assets. The investor should obtain internal reports, notices or correspondence relating to any purported violation or infringement by the company, or any of its subsidiaries, of any government regulation. This applies not only to telecoms regulation but also areas such as consumer protection and trade practices. If the target's licence is subject to build-out obligations (which require a mobile company to own the facilities needed to serve a predetermined proportion of the population within some specified time period after its receipt of the licence), it is important to establish whether they have been met and if timely notice has been given to the regulator. If not, it could lose its licence or right to exclusivity. Enquiries must also be made as to whether the target has received complaints about its billing or advertising. In the US, complaints of this nature may be a precursor to consumer class actions.

Privacy regulation

Due diligence should include a review of the target's privacy policies, and its compliance with the privacy regulations of every jurisdiction in which it operates, particularly if the target serves the mass market. In Europe, Parliament and Council Directive (EC) No. 46/1995 on Data protection and Parliament and Council Directive (EC) No. 58/2002 on the Protection of privacy in the electronic communications sector (which contain rules specific to the electronic communications sector) impose a set of onerous mandatory requirements. The US lacks any single, comprehensive set of privacy rules, but it does impose restrictions on whether and how providers of fixed and mobile services may use or share customer proprietary network information. Perhaps more importantly, if a target is not in compliance with privacy rules and this fact is publicised, its reputation in the market may suffer significant harm. This in turn may harm the buyer's reputation and value in the marketplace. Equally, compliance with privacy regulations may require the acquisition of sophisticated technology or implementing cumbersome compliance procedures (or both). If these are not already in place, a buyer should be informed of the potentially significant costs of bringing the target into compliance with applicable privacy rules.

Pending government proceedings

Telecoms regulatory regimes and the markets they affect are in the process of changing, as they have been for at least a decade. For example, the UK Office of Communications (Ofcom) is considering both its general approach to telecoms regulation and a range of measures, including either a new regulatory framework to ensure that competitors get access to bottleneck facilities of BT equivalent to BT's own retail activities or, failing this, structural separation of BT. Ofcom is also contemplating changes to the allocation and treatment of spectrum that, if adopted, would erode or eliminate the exclusive rights of incumbents. Both initiatives are likely to set a precedent for other EU member states' treatment of similar issues. In the US, the FCC is reducing the rights of competitors and moving toward giving incumbent telecoms companies regulatory parity with cable companies. In all jurisdictions the emergence of VoIP services is raising questions about the viability of traditional business models. Due diligence cannot determine how these developments will affect the target's business, but it can give the buyer the most recent, available information as to whether and to what extent they have been taken into account in the target's business plans and accounts.

Surveillance requirements

Some jurisdictions require telecoms operators to have equipment and software to enable law enforcement and security agencies to conduct lawful electronic surveillance of certain network traffic. Satisfying these obligations can be costly. An investor should ensure that the target complies with all surveillance facilitation requirements. This is particularly true if the target is a small company, because the cost of compliance may represent a significant proportion of a small company's resources.

Competition regulation

A buyer should determine whether its purchase of a target will trigger thresholds requiring notices to competition agencies and

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whether the investment will generate any serious concern by those agencies. These may prevent, delay or impose conditions on any contemplated transaction and need to be assessed at an early stage. Regulators often consider not just the two nominal parties to the sale, but also other related parties. EU and US competition authorities have staff with particular expertise in telecoms, as a result of the number of transactions that they have reviewed over the years and the issues raised by the presence in almost every jurisdiction of a national incumbent. Telecoms regulators may have overlapping jurisdiction to consider an acquisition's effects on competition in a given market or markets, and may have rules concerning permissible levels of concentration.

Contracts

The investor should evaluate all significant contracts to which the target company is a party. The target's customer contracts underpin its revenues, whilst its supply and employment contracts are important for assessing its costs and the scope for cost-savings.

Customer contract due diligence should review all material customer contracts, including those with national, state, municipal or foreign governments, which may often contain unusual terms. The buyer should also verify that the target has not been disqualified from obtaining government contracts in any jurisdiction (this has occurred to companies that have undergone corporate governance scandals).

Contract due diligence should also consider the duration, price, general terms and terms relating to a change of control or the ability of the seller to assign the contract. Relationships between business customers and key sales people should also be considered. Retaining employees with important customer relationships facilitates the continuity of the business and revenue streams.

In assessing supply contracts, a buyer should determine the extent of the target's spending commitments which may limit the scope for cost-savings. Many equipment and network, supply and maintenance contracts are long-term, so the buyer should assess their compatibility with their plans for post-acquisition integration and any changes to the scope of the target's business.

Particularly in Europe, the scope of employee protection and pension obligations can be a surprise for US investors. These complex areas are not telecoms specific and so are not described further here.

Accounts and Sarbanes-Oxley

Under the US's Sarbanes-Oxley legislation, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of companies whose shares are registered with the US Securities and Exchange Commission (SEC) must certify the accuracy of their annual and quarterly financial statements and public reports. The legislation applies to non-US companies whose shares or American depository receipts are listed on US exchanges.

Although Sarbanes-Oxley is of general application, a variety of practices can obscure the financial health and value of a target in the telecoms sector. If the CEO and CFO of a listed company have not certified the target's financial statements and public reports in accordance with Sarbanes-Oxley, that should indicate potential issues for further investigation.

CONCERNS FOR PROVIDERS OF SPECIFIC TELECOMS SERVICES

Various additional due diligence issues arise with respect to particular types of telecoms-related service providers.

Fixed

The key areas for further due diligence into providers of fixed telecoms services are interconnection and local loop unbundling or sharing agreements, and potential regulatory developments affecting those agreements.

The most important cost of a competitive fixed company is the amount it must pay the incumbent for interconnection services and the use of the incumbent's other facilities. In contrast, one of the most important revenue streams for an incumbent telecoms operator is wholesale revenue. This cost or revenue is generally governed by the fixed company's interconnection agreement with the incumbent. Whether the target is an incumbent or a competitive operator, the buyer must understand the effect of regulatory decisions that may reduce wholesale prices or allow the incumbent to increase these prices. This exercise involves analysing the relevant contracts, the regulatory environment and relevant decisions.

Another key question is purely regulatory: whether and to what extent the incumbent can raise or lower its retail prices for services. If it can raise those prices, the target should be able to raise its own under the incumbent's price umbrella. If the incumbent can lower its retail prices, the target may not have adequate room to manoeuvre between the regulated wholesale price and the retail prices.

A specific US issue is the right of a competitor under US telecoms law to charge the incumbent for transporting to the competitor's customer a call originating on the incumbent's network. If a target is a competitor that earns substantial revenues from reciprocal compensation, the target's interconnection agreement(s) and the applicable regulatory requirements must be carefully reviewed.

Mobile

Both the regulatory environment and the market structure differ between the US and the EU, and this gives rise to different due diligence concerns.

In the EU, the key concerns are the possibility that additional competitors may be licensed, the regulation of mobile termination fees and the regulation of international roaming arrangements. Although mobile operators provide electronic communications services under a general authorisation, their authority to use spectrum is by way of a (generally non-transferable) individual licence that often restricts the use of the spectrum (for example, to either Global System for Mobile Communications (GSM) or Universal Mobile Telecommunications System (UMTS) service) and may require service to be rolled out to cover a high percentage of either the country or the population. Since investment returns correlate strongly with the concentration of the national mobile market, the prospect of either competition by the award of new licences or liberalisation

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of spectrum use is important for buyers. Wholesale mobile termination charges and international roaming charges are significant sources of high-margin revenue for EU mobile operators; however, both areas have been investigated by European and national regulators, so a buyer should understand both the current regulatory regime and likely future developments.

Licences may be transferred in the US and similar jurisdictions. In the US, there are four providers in most large metropolitan areas, and the top four providers offer nationwide plans that impose no roaming fees. Even though the FCC alone has authority to impose entry and rate regulation on mobile providers, all states subject those providers to various consumer protection regulations, and some states impose approval, notification, registration and other requirements. Therefore, appropriate due diligence requires inquiry into compliance with state as well as national regulation.

A potential investor in a US target should ensure that the target has title to the licence and that there are no adverse conditions or encumbrances on that licence. FCC restrictions on licences, which may vary from band to band, frequently impose limits on the duration and transferability of the licence, maximum power levels, requirements to adhere to certain technical standards, and build-out obligations. In addition, an "Enhanced 911" obligation requires mobile providers to be able to determine the location of a caller in need of emergency services. Compliance with these requirements must also be investigated.

Another important consideration is the ease of deploying base station radio equipment, which determines the reach and quality of services provided, in the geographic area where the target operates. In Europe, health concerns and planning restrictions often make this difficult or more costly. As with fixed operators, the status of the target's important contracts, such as transmitter leases, equipment contracts, roaming and interconnection agreements should be reviewed.

Internet

Many experts in the telecoms industry predict that consumers will flock to VoIP services for their voice communications. The profitability of any VoIP business depends in part on the costs and benefits rendered by the applicable regulatory environment. The status of VoIP regulation is a key area for due diligence. Today, some VoIP services are free from the costs of traditional telecoms regulation (such as access charges in the US), and some are not. In the EU, although opportunities for rate arbitrage appear less than in the US, there is an ongoing debate about how consumers are adequately protected and the extent to which services should be regulated as a publicly available telephone service. In the US, the FCC has ensured, for now, that a VoIP service between just VoIP subscribers (a peer-to-peer service) is unregulated, but it has not moved to exempt services between VoIP subscribers and users of traditional telephone services. In any event, these exemptions are unlikely to remain in place if substantial numbers of consumers do in fact move to VoIP.

In the US, some relevant and unresolved regulatory disputes include:

- Whether VoIP services should be subject to access charges to the extent that they permit subscribers to call persons connected to the public service telephone network.
- Whether state governments should have any right to regulate any VoIP and other IP-enabled services.
- Whether and to what extent VoIP services should be subject to the full scope of regulations governing providers of traditional voice communications.

The last of these debates mirrors the discussion in the EU, and in both regions this discussion includes the following issues:

- Emergency service access.
- The provision of location information to emergency services.
- Tariff filing requirements.
- Obligations to ensure that the service is accessible to, and usable by, individuals with disabilities.
- Co-operation with the wiretapping needs of law enforcement.
- Contribution to any applicable universal service funds.

Cable

Where the acquisition target is a cable company, the buyer or investor should investigate a range of regulatory obligations. In the US, a cable company obtains its essential licence (or franchise) from a municipal government, which may impose particular conditions on a licencee. For example, licencees are often required to reserve channels for government and educational programmes. As a result of federal requirements, licencees are subject to "must carry" rules, which give over-the-air broadcasters a statutory right to have their programming carried on the local cable system. A separate "retransmission consent" provision prohibits cable companies from retransmitting most broadcast signals without first obtaining the express authority of the originating station. A buyer should, in addition, ensure that the target has any FCC microwave licences (called CARS) needed to transport programming from satellite to local facilities; the transfer of these licences may require FCC approval. Finally, although cable companies' internet access services are, so far, free from telecoms regulation, this is not likely to last with the growth of VoIP services.

In the UK, the two cable operators, ntl and Telewest, offer a "triple play" service (telecoms, television and broadband) and they are correspondingly subject to broadcasting as well as telecoms regulation. Therefore, in their telephony and internet businesses the considerations noted above for fixed and internet business are also applicable. As in the US, programming contracts and costs, together with customer numbers and churn rates, are key considerations for investors.

EQUIPMENT AND SOFTWARE MANUFACTURERS

Relatively few telecoms regulatory issues arise for equipment and software producers. The principal ones concern certification or type approval of equipment. Other, non-regulatory issues are

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often important.

A buyer should confirm that intellectual property (IP) created by the target's employees belongs to the employer. A manufacturer normally should accomplish this by invention assignments, which are widely used and commonly enforced contractual arrangements. Traditional invention assignments may not be sufficient to protect IP rights for material developed by outsourced labour, as the persons doing the work may not be employees of the company outsourcing its work. It is therefore important that any of the target's outsourcing contracts be reviewed for provisions clearly protecting its IP rights. In the UK there is a presumption that an employee's inventions belong to their employer, but it is usual for an employee's contract of employment to provide for express assignment. Both the UK and the US require an explicit assignment for outsourced, contract or third party development.

If the target produces software, the investor should determine whether the target's employees used open source code during the development process, because doing so can place the target's own software in the public domain.

The buyer should review all key provisions of the target's major contracts, especially provisions governing duration, termination, pricing and liabilities. Particular attention should be paid to contracts with high-volume business customers, as these typically account for a large proportion of the income generated by telecoms equipment and software manufacturers. Because the target's assignment of the contract to the buyer may sometimes require the approval of the other party to the agreement, the buyer should review any assignment or change of control provisions with extra care.

The buyer should review and consider all non-competition clauses in joint ventures and contracts, including IP licences. If the target has agreed not to compete against the third party in a connected business sector, the non-compete clause may, depending on the jurisdiction and the specific language used in the clause, extend to the acquiring company and its affiliates. If the target's contracts include a non-compete clause, the acquirer should determine whether the relevant jurisdictions regard these clauses as unenforceable as a matter of public policy.

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