

Getting Your Deal Done – Considerations For Selling And Buying Small Systems

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As the economy firms up, we see increasing activity in the selling and buying of small cable systems. Clustering, spin offs, market reentry by cable veterans, all are resulting in more interest and action in small cable deals. While some parts of a small cable deal are like any other transaction, many aspects are unique. After all, cable is still a heavily regulated business, and a cable system has several types of assets that warrant careful consideration before and during the sale process.

To help you better plan for a purchase or sale, we have prepared a two-part series on considerations in selling and buying a small cable system. We break the sale process down into four steps. Of course, these steps occur after you and your broker have found a potential buyer or seller. The four steps are:

- Letter of Intent
- Due Diligence
- Purchase Agreement
- Closing

This installment focuses on the letter of intent and due diligence.

Letter of Intent

At the start of any cable transaction, we nearly always recommend that the parties sign a letter of intent. The letter of intent summarizes the key terms of a proposed deal, and may contain several important restrictions and obligations.

Generally, the letter of intent will state that it is not “binding.” In other words, the parties are not obligated to close the transaction until a formal purchase agreement is signed. Still, the letter of intent can be a very important instrument because it commits to paper the parameters of a transaction and serves as a roadmap for the purchase agreement. While a letter of intent overall is generally not binding, it may contain certain terms that are binding obligations. For example, the letter of intent may contain confidentiality provisions and a time-limited “no-shop” clause.

A letter of intent is by no means required. Sometimes the parties will immediately begin drafting a purchase agreement without the intervening step of a letter of intent. As you will read below, however, a well-crafted letter of intent can lend clarity to the transaction at the outset and provide both the buyer and the seller with important protections while a definitive purchase

agreement is being drafted. Even if a letter of intent is not signed and the parties go straight to a purchase agreement, the considerations discussed below still apply.

Important provisions in a letter of intent include:

- Purchase price. The letter of intent should specify the purchase price, and any major adjustments to that price. Most cable transaction today will reduce the purchase price if the basic subscriber count falls below an established threshold. Another area to flesh out at the outset is the form of the purchase price. Will it be paid in all cash, stock of the buyer, a promissory note? Depending on the potential buyer, any of these options or a combination of them may make sense. Finally, often a portion of the purchase price will be held back by the buyer until some time after the closing. Known as a “holdback”, this type of provision puts money behind the seller’s representations and warranties.
- Form of transaction – assets or stock. A letter of intent should specify if the transaction will be structured as an asset or a stock deal. In an asset deal, the buyer is buying the assets of the cable system – the physical plant, subscriber goodwill and the rights under the franchise. Buyer’s generally prefer an asset deal because the buyer can specify which of the seller’s liabilities the buyer will assume. In a stock deal, the buyer purchases all of the stock of the seller, thus buying the company as a whole. This means that the liabilities of the seller come along with the assets. The form of transaction can have significant tax implications for buyers and sellers.
- “No-shop” clause. One of the main reasons buyers often want a letter of intent is for the “no-shop” clause. This is the seller’s agreement that, for some specified period of time, the seller will not make any efforts to find or negotiate with other potential suitors. The buyer’s justification for getting this protection is reasonable – the buyer is prepared to incur legal fees to have a purchase agreement drafted and will also be expending substantial resources to perform due diligence. That said, the seller is justified in attempting to limit the time period to one sufficient for the buyer to perform due diligence, but not much longer.
- Information and confidentiality. At some point, the seller will be expected to “open the kimono” and share sensitive information with the buyer. Letters of intent often memorialize this expectation by requiring the seller to provide the buyer with access to its books, records, and, sometimes, employees. The buyer’s review of this information is called due diligence and is discussed in more detail below. Before sharing any confidential or sensitive information with a potential buyer, the seller should insist that the buyer execute a confidentiality or non-disclosure agreement. This often happens even before the execution of a letter of intent. If no separate

agreement regarding confidentiality has been signed, the buyer should insist that one is included in the letter of intent.

One final caution regarding confidential information. The Communications Act prohibits a cable operator from disclosing personally identifiable subscriber information. This prohibition does not, however, prevent a cable operator from disclosing aggregate data which does not identify a particular person.

A final word on letters of intent – have a lawyer review any letter of intent before you sign it. One party will often argue “the letter of intent is informal – your lawyer will have a cut when we negotiate the purchase agreement.” If you have read this far, however, you know that a number of the most important terms may be decided at the letter of intent stage. Lawyer review at this stage is critical.

Due Diligence

For the buyer, an important step in the acquisition process is conducting “due diligence.” Due diligence is the process during which a potential buyer gathers and evaluates information about the seller’s company. In a cable deal, the seller can expect the buyer to focus on these areas:

- Financial due diligence. The buyer will want to review the seller’s financial statements. In particular, the buyer will focus on revenues attributable to subscribers and subscriber counts.
- Physical due diligence. The buyer will often inspect headends and portions of the cable plant.
- Legal due diligence. The buyer will review the franchise and other material contracts relating to the company. One area of particular attention is in regulatory compliance such as copyright filings, regulatory fee payments, tower compliance, and signal leakage testing.

From the seller’s perspective, due diligence can be a frustrating process as the buyer may make seemingly endless requests for information. This is often the case, however, when the seller’s system and company records are not in order. For a seller, implementing sound record-keeping practices and making sure regulatory compliance is in order can go a long way to easing this process.

In next month’s issue of the *Independent Cable News*, we will discuss the purchase agreement and the closing.