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CLEAR AND PRESE

NT DANGER

Most favored nation clauses can "muddy the water" between operators and the channels they carry. Here are some words of caution that could help avoid that possibility.

By BRUCE LAZARUS & RAOUL DE SOTA

IT'S TIME TO BREAK OUT THE CHAMPAGNE. After months of negotiations, you've just signed a carriage agreement for the cable network you help run. And a major cable, satellite or telco distributor is about to give your channel exposure in several million homes across the U.S. It's the christening of a relationship that you hope will be long lasting and profitable. You've expended a lot of energy to limit the amount of ambiguity in the agreement, which is exhaustively detailed in pages, paragraphs and clauses to insure that the terms of the relationship are clearly understood by both parties.

But chances are, if you're like most channel executives negotiating with major operators, there is one clause in the document that could prove to be a problem child, flying in the face of this guiding principal of clarity: the Most Favored Nations (MFN) provision.

Put simply, operators who insist on MFN clauses are saying: "If you give another operator a better deal than you gave me, then our agreement may have to change to reflect the more attractive terms and conditions – be they economic or non-economic."

To the untrained eye, providing fair treatment by virtue of an MFN may seem like an uncomplicated matter. In reality, crafting the language of such clauses is usually a time-consuming, difficult and not all together satisfying experience. After the ink has dried, both parties may still be asking themselves what they truly gained or lost in the process. The greater the complexity in these clauses, the more difficult it becomes to realistically assess where your organization stands with respect to compliance and financial exposure.

Now more than ever before, operators are exercising their rights to assure the MFN clauses are not ignored. One typical way of doing that is to require programmers to fill out annual Letters of Certification, which legally document that the programmer is giving the operator equal treatment – if not better treatment – than any other operator client.

Programmers need to have done the necessary assessments before they receive one of these letters. This is not so much for the legal implications. Litigation is rare when it comes to rectifying MFN non-compliance. Instead, if programmers haven't maintained the leverage equation, they're likely to find themselves at an economic disadvantage when it comes time to renew the contract. If you, as a programmer, have MFN clauses in a number of contracts, one issue involving disparity is likely to cause a domino effect, instigating debates about inequality with other distributors. From a financial perspective, you clearly hope that these remain ripples and not large waves.

Ironically, while MFN clauses are meant to create a level playing field, that's not always achievable. The metrics used to evaluate and enforce such clauses are not universally accepted or tested, and they are open to multiple interpretations. Because there's no clear methodology for actually calculating economic compliance, fairness can become a major brainteaser. Further clouding the picture: in many instances, MFN provisions include "non-economic" terms and conditions, which cannot be quantified and evaluated to insure compliance.

If an MFN clause is unavoidable at the time you're negotiating an affiliate agreement, you can minimize future conflicts by paying special attention to the language contained in the contract, and clearly understanding the risks.

NET EFFECTIVE RATE CALCULATION: This is an economic barometer that measures all monetary influences found within an agreement. There needs to be an acceptable definition clearly outlined within your MFN that helps you calculate

this equation. And, by doing so, you are in an unambiguous position to manage it on an ongoing basis. Additionally, there has to be a methodology established so that this can be regularly tested.

NON-ECONOMIC TERMS: Unless you are specific about what non-economic conditions will render your MFN compliance unenforceable, you leave yourself open to future debates. Detail specific examples that will underline the intent. This is very much a "lazy man's provision" in the sense that it tries to cover all other supposed holes that a negotiator can't think of right now, so they all get thrown in to this bucket. One example of a non-economic term could be an unpaid channel positioning within a tier.

EVOLUTION OF DISTRIBUTION PLATFORMS: The worst thing you can do in an agreement is unduly surrender your rights as an originator of television product. When you sign up with a distributor, you are obviously playing in someone else's sandbox, so it would be reasonable to expect to have to abide by their rules. But this becomes egregious when the contract forbids your right to explore alternative distribution platforms – some of which may be owned by rival multichannel operators, mobile carriers and Web sites.

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Cable operators have begun to raise concerns about networks that provide full episodes of programs online for free, when the operators are paying carriage fees for the right to carry the same content. So alternative platforms are a very sensitive topic that needs careful exploration.

SARBANES-OXLEY COMPLIANCE TESTING: Recent legislation, such as Sarbanes-Oxley, has given publicly traded entertainment companies with cable network ownership a big incentive to focus on MFN compliance. A MFN violation is a liability that needs to be quantified and reflected on all audited financial statements. Overlooking or gambling on your MFN provision, so that your financial statements overestimate your revenue base, is not looked upon kindly by the federal government.

FINANCIAL RISKS: The consequences and the monetary damage resulting from non-compliance of an MFN clause have changed over time. Fifteen years ago, a MFN violation would, much like today, impact only a few distributors, because not every distributor has the clout and leverage to incorporate a MFN provision in their distribution agreements. And at that time, the largest operators served a much smaller number of subscribers than they do today. As a consequence, MFN violation would only be a minor inconvenience to the cable programmer, as the financial exposure would be relatively low and limited to only a few effected distributors.

Today is a different matter. A violation can trigger a series of violations. One violation can ripple out to just a few distributors, but they may serve 65 million households, or more. The impact to a network's P&L and balance sheet could be significant and material.

CREATIVE DEVELOPMENT RISKS: A more subtle consequence of the MFN provision is the stifling of creativity at cable networks. A cable network's capacity or desire to customize an affiliation agreement to suit the specific marketing and financial needs of a distributor becomes hampered by the net effective rate calculation and other limiting terms. The clause becomes just another tool for distributors to extract additional concessions from programmers after its agreements have been signed. In a nutshell, content development investments and marketing support should be kept as far apart as possible. Developing highly targeted programming content for different regions of the U.S. cannot be treated uniformly across all geographies and all MSOs.

Content providers must decide, in a forward-thinking way, how they can avoid financial risks associated with MFN compliance. One of the worst consequences of a MFN provision is that it becomes an agreed upon contract provision and then is quickly forgotten until a distributor requires a letter of certification acknowledging compliance. The decision to include a MFN provision is a process that not only begins during the crafting of the language, but must incorporate the management of the provision over time to insure constant compliance.

This industry needs to take a harder look at its current standing with regard to compliance assessment of MFN clauses and to what extent these provisions inhibit or promote future growth strategies. As the distribution environment becomes ever more dynamic, the initiative for change must come now to resolve existing ambiguities so that future opportunities can be assessed properly.

Bruce Lazarus is CEO of Cable Audit Associates, which provides independent subscriber auditing services for the multichannel industry. He can be reached at blazarus@cableaudit.com or 303-694-0444. Raoul De Sota is senior vice president of strategic development at Cable Audit. He can be reached at: rdesota@cableaudit.com or (720) 407-7546.

MFN SOLUTIONS

The Review Process

- Catalog all your MFNs agreements
- Create a standard methodology for the review process
- Form an MFN review committee, and make sure they review contracts for compliance issues not only as they are coming up for renewal, but also on a regularly scheduled ongoing basis

Legal, Finance, Affiliate Sales Actions

- Create standard MFN language to allow for comparative analysis
- Incorporate an MFN review process into Sarbanes-Oxley compliance testing
- Develop quantitative analysis to evaluate all MFN restrictions
- Define the "Net Effective Rate Calculation"
- Review all MFN agreements on an annual basis
- Create control and review process to monitor and prevent potential MFN breaches after agreements are signed
- Allow for independent review for ongoing consistent and unbiased interpretation
- Benchmark MFN language for risk assessment
- Expand outside counsel involvement to maintain attorney client privilege
- Define MFN audit methodology and restrictions
- Disclose potential violations as soon as possible