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Expert Analysis

In a Cord-Cutting World, Only the Strong Contracts Survive

The digital revolution has invaded all things media: Music stores have given way to digital downloads, video rental shops have disappeared, and subscription video-on-demand streaming services have exploded. As technological advancements have forced most of the entertainment industry to evolve or become extinct, the traditional cable TV bundle continues virtually intact. Yet, according to a May 2014 Nielsen report, while the average U.S. television-watching home receives 189 channels, TV watchers consistently tune in to just 17.[1] Indeed, a steady stream of customers have cut the cable cord in favor of accessing content from alternative sources.

To avoid being left on the "cutting" room floor, certain cable industry leaders are pursuing strategic initiatives to appeal to the cord-free generation. These changes stand to significantly alter the longstanding relationship between programmers and distributors. But, the existing contracts between programmers and distributors may limit the type of changes that either party may make, and when. While it's "prime time" for change among consumers, the black letter law of contracts may keep the bundle strings tied tight.

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The Basics of the Bundle

The cable television industry offers programming in "bundles," requiring consumers to purchase a pre-packaged group of networks in order to gain access to any one network. Generally, distributors require customers to purchase either a "basic" or "expanded basic" tier. The "basic" tier often includes local broadcast stations and educational, governmental, and public access networks, as mandated by the Federal Communications Commission under "must-carry" laws.[2] An "expanded basic" tier typically contains the most popular networks.[3] Distributors then offer several "premium" tiers for a higher fee, including networks such as HBO and Showtime, as well as genre-specific packages (e.g., sports, children's programming).

Distributors make money by charging subscribers a monthly fee based on their tiers, which increases in cost based on the number of networks included in the tier, and the number of packages purchased. Programmers make money through license fees charged to distributors, usually based on a per-subscriber basis per network licensed. The more subscribers receiving the network, the more license fees are paid. Programmers also make money through advertising, which rates are dependent on how widely a network is distributed—more viewers mean more money.

Contracts between programmers and distributors generally dictate how distributors will carry the licensed networks. These provisions often specify the tier on which an individual network must be carried, or require that it be packaged with other comparable networks. If a programmer has a very popular network, it can bargain for the inclusion of that network, and possibly its other, less popular networks, on a distributor's "most widely distributed" tier (i.e., the tier with the most number of that distributor's subscribers). Contracts

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may also contain a "penetration" requirement, either in addition to or instead of "tier" or "packaging" requirements. A "penetration" requirement may mandate that a particular percentage of a distributor's subscribers receive a specific network. Under this scenario, the distributor carries the network however it wants, but ensures that the required percentage of its subscribers receives the network. Provisions regarding how a network is carried are the backbone of contracts between providers and distributors.

The programmers' practice of licensing networks as a bundle has been attacked before, as an unlawful "tying" arrangement in violation of Section 1 of the Sherman Act. For example, in *Brantley v. NBC Universal*, 675 F.3d 1192 (9th Cir. 2012), a class of cable and satellite subscribers filed suit against a group of programmers and distributors, alleging that the programmers' practice was anticompetitive and seeking to compel programmers and distributors to sell channels separately. In *Brantley*, the "injury" alleged from the act of bundling networks was that such conduct "limit[ed] the manner in which Distributors compete with one another in that Distributors are unable to offer a la carte programming, which results in…reducing consumer choice, and…increasing prices." Id. at 1202.

The U.S. Court of Appeals for the Ninth Circuit upheld dismissal of the plaintiffs' claim, concluding the bundling arrangement was a "freedom" of "contracting parties," and any resulting reduction in consumer choice or increase in cable prices was "fully consistent with a free, competitive market" and not plausibly indicative of "anticompetitive" behavior. Id.

In 2013, another antitrust suit was filed against the programmers, this time by a distributor, switching from friend to foe. Cablevision (distributor) alleged that Viacom (programmer) was bundling its more popular networks with its lesser-watched networks, in violation of Section 1 of the Sherman Act. See *Cablevision Sys. Corp. v. Viacom Int'l*, No. 13 CIV. 1278 LTS JLC (S.D.N.Y. March 7, 2014). Cablevision asserted that its licensing agreement, which required Cablevision to contract for dozens of Viacom's networks to obtain "four commercially critical" networks, had prevented Cablevision from purchasing content from other programmers. Id., 2014 WL 2805256, at *1 (S.D.N.Y. June 20, 2014).

In June 2014, the court denied Viacom's motion to dismiss, finding sufficient allegations to support an "inference of anticompetitive effects." Id. The outcome of this case may greatly impact the economics of the bundle: If Viacom's strategy is found to be "anticompetitive," and the programmer bundle forced to be broken, it may reduce the number of networks a distributor chooses to license and, therefore, the fees it pays (and presumably, the fees its customers pay).

Custom Cable? Not So Fast

Consumers who watch only select networks in the bundle have only one meaningful alternative to paying for channels they don't watch—"cut the cord" and opt out of cable altogether. Distributors have therefore pursued new initiatives to keep these customers. In April 2015, Verizon launched a pared-down (in number of networks and in price) "custom" cable TV bundle, likely hoping lighter cable bills will keep customers from cutting cords. The "custom" bundle, however, notably omits the ESPN networks. ESPN, the leader in sports broadcasting and longtime pillar of Verizon's basic cable bundle, sued Verizon over this new product.[4]

In *ESPN v. Verizon Services Corp.*, filed in state Supreme Court, New York County,

ESPN seeks to "enforce [Verizon's] contractual obligations to [ESPN]," "enjoin [Verizon] from unfairly depriving [ESPN] of the benefit of its bargain," and "require [Verizon] to pay damages to [ESPN] in an amount consistent with (but not limited to) relevant provisions in the parties' agreements."[5] According to ESPN, its contracts "clearly provide that neither ESPN nor ESPN2 may be distributed in a *separate* sports package."[6] Verizon, however, has a different view: "Consumers have spoken loud and clear that they want choice, and the industry should be focused on giving consumers what they want," and Verizon is "well within [its] rights under [its] agreements" to offer customers these choices.[7]

Contract Is King

Under New York law, whether a contract provision is "ambiguous" is a "question of law" for the court. *Eternity Global Master Fund v. Morgan Guar. Trust Co. of N.Y.*, 375 F.3d 168, 178 (2d Cir. 2004) (quoting W.W.W. Assocs. v. *Giancontieri*, 566 N.E.2d 639, 642 (N.Y. 1990)). Similarly, interpretation of an "unambiguous" contract is a "question of law" to be addressed by the court. See *Provident Loan Soc'y of N.Y. v. 190 E. 72nd St. Corp.*, 78 A.D.3d 501, 502 (1st Dept. 2010). The court must avoid interpreting a contract in a manner that would be "commercially unreasonable, or contrary to the reasonable expectations of the parties." *In re Lipper Holdings*, 1 A.D.3d 170, 766 (1st Dept. 2003) (internal citations omitted).

New York law provides that a contract is ambiguous only if "the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings." *HarperCollins Publishers v. Open Rd. Integrated Media*, 7 F.Supp.3d 363, 370 (S.D.N.Y. 2014). The existence

of ambiguity in a contract is determined by examining the "entire contract and consider[ing] the relation of the parties and the circumstances under which it was executed," with specific provisions to be considered in light of the contract "as a whole and the intention of the parties as manifested thereby." *Goldman Sachs Grp. v. Almah*, 85 A.D.3d 424, 426-27 (N.Y. 2011).

Parties cannot "create an ambiguity merely by urging conflicting interpretations of their agreement." *Sayers v. Rochester Tel. Corp. Supplemental Mgmt. Pension Plan*, 7 F.3d 1091, 1095 (2d Cir. 1993). In the Verizon/ESPN case, the details of the contract are not publicly known. There is little doubt that both parties will contend their interpretation is unambiguously correct, but ultimately it will be a question for the court.

Verizon's move is an obvious attempt to maintain its position in the face of shifting consumer preferences. However, this is not the first time a media giant has adjusted its business model to keep pace with changed circumstances. For example, in *Boosey & Hawkes Music Publishers v. Walt Disney Co.*, 145 F.3d 481 (2d Cir. 1998), plaintiff was an assignee of composer Igor Stravinsky's copyrights which granted distribution rights to Stravinsky's composition "The Rite of Spring" for use in the Disney motion picture "Fantasia." It filed suit in the Southern District of New York seeking a declaratory judgment that the terms of a 1939 license agreement forever restricted Disney's distribution of "Fantasia" to certain types of movie theaters, and not by any other means. The district court agreed with the plaintiff.

The U.S. Court of Appeals for the Second Circuit reversed, holding that the contract language restricting distribution was ambiguous. In remanding the case for a trial to determine the scope of the agreement's distribution rights, the court gave credence to the fact that "a result which deprives the author-licensor of participation in the profits of new unforeseen channels of distribution is not an altogether happy solution."[8] Nonetheless, it recognized it is "more fair and sensible than a result that would deprive a contracting party of the rights reasonably found in the terms of the contract it negotiates."[9] In other words, basic principles of contract interpretation determine the parties' rights. Indeed, regardless of the circumstances, how much and how soon a company can evolve will be restricted by the court's interpretation of the contract.

Future contracts between distributors and programmers may break the cable bundle in order to prevent alternatives, like online video distributors, from leading customers astray. But for now, as New York law teaches, the existing contracts are key: When the plain, ordinary meaning of the contract lends itself to only one reasonable interpretation, that interpretation controls. If a contract prohibits certain types of network packaging, or requires certain penetration levels of distribution, those provisions cannot simply be avoided without consequences (or renegotiation for greater exchanged value). However, if a contract is "reasonably read" to allow certain conduct, "the party benefitted by that reading should be able to rely on it," while "the party seeking exception or deviation from the meaning reasonably conveyed by the words of the contract should bear the burden of negotiating for language that would express the limitation."[10]

One thing is certain—attorneys and clients on both sides of the bargaining table must pay close attention to how obligations are written in agreements between distributors and programmers in order to address ever-increasing threats to the cable bundle. Yet for today, it seems only fitting that a basic rule of contract law, unaffected by changing times or technology, will determine disputes arising out of those changes. In the match-up between programmer and distributor, there can only be one King of the courtroom, and it is the contract.

Endnotes:

1. "Changing Channels: Americans View Just 17 Channels Despite Record Number to Choose From" Nielsen (May 6, 2014), http://www.nielsen.com/us/en/insights/news/2014/changing-channels-americans-view-just-17-channels-despite-record-number-to-choose-from.html.

2. Implementation of the Provisions of the Cable Communications Policy Act of 1984, 50 FR 18637-01 ("Basic cable service is the tier of service regularly provided to all subscribers that includes the retransmission of all must-carry broadcast television signals as defined in §§76.55 to 76.61 of the rules").

3. Id.

4. See Summons, *ESPN, Inc. v. Verizon Services Corp.*, No. 15-651391 (Sup. Ct., New York Co., April 27, 2015) (Doc. 1).

5. Id.

6. Id. (emphasis added).

7. CNN Money, "ESPN steps up battle against Verizon," CNN (April 27, 2015) http://money.cnn.com/2015/04/27/media/espn-sues-verizon/index.html?category=media.

8. Id. at 486.

9. Id. at 487.

10. Id.

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