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The Role of Audits by Local Governments of Telecommunications Providers

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INTRODUCTION

Municipal right-of-ways ("ROW") are essential corridors that provide a vital pathway for transportation, communications and economic development in a community. The ROWs accommodate pedestrian and vehicular traffic, shade trees, traffic signals and signs, street lights, water mains, storm and sanitary sewers, gas lines, electric wires, as well as telephone and cable television wires that deliver communication services. Management of municipal ROWs is therefore a process of balancing multiple demands on the same property.

Municipalities impose fees on ROW users not only to recover the fair rental rate for occupation of the ROW but also to reimburse the municipality for the disruption of the ROW. Such disruption imposes a financial burden that should not be borne by a municipality but rather by the entity using the ROW. The financial burdens on municipalities from ROW occupation include:

1) initial disruption caused by system construction;

2) reduced value (integrity/life span) of the ROWs following multiple street cuts;

3) difficulty accessing municipal or existing private provider facilities in an already crowded ROW;

4) ongoing maintenance and oversight related to the ROW occupation; and

5) added cost of ROW replacement given the presence of added facilities that must be relocated.

While some states may limit fees or ROW compensation to recover only the "actual cost of managing the right of way".[1] However, several courts have found that "the term 'compensation' has long been understood to allow local governments to charge rental fees for public property appropriated to private commercial uses.[2]

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[1] For example, Minn. Stat. Section 237.162, subd. 9, defines the cost of managing the rights-of-way. See also Minn. Rules pt. 7819.1000.

[2] *See TCG Detroit v. City of Dearborn*, 205 F. 3d 618 (6th Cir. 2000); (The district court's decision can be found at 16 F. Supp. 2d 785 (E.D. Mich. 1998) (upheld a district court decision finding that a 4% franchise fee was permissible under Section 253(c)).

This summer the Federal Communications Commission ("FCC") initiated a proceeding seeking information that could potentially be used to establish "uniform rates" for the occupation of ROW. The FCC has sought information about market based rates, per-foot or percentage of revenue, identifiable cost, processing fees, recurring and non-recurring charges, and recovery of cost.[3] While the FCC gathers information that could potentially impact the level of fees municipalities are entitled to collect, many municipalities may well be losing hundreds of thousands of dollars from ROW users that are not remitting fees required under existing franchises, state or local law. For example, in Portland, Oregon, the City collects over $60 million per year in franchise fees and only 6% of that amount is generated from cable television providers. Portland routinely reviews and audits the payments made by ROW users and has uncovered millions in unpaid fees over the last decade.

WHAT IS A FRANCHISE FEE?

A franchise fee is paid by a ROW user to a municipality for the privilege of using the ROW or to compensate for the costs of regulation. It is the single most important element in any franchise and has resulted in numerous disputes between municipalities, and ROW users. Absent provisions in a franchise to the contrary, nothing under federal law prohibits a municipality's use of franchise fees for any purpose it desires. For cable television operators, the Cable Act (47 U.S.C. § 542(i)) specifically prohibits the FCC from regulating the use of revenue derived from franchise fees.

This paper will review FCC and court decisions affecting municipal authority to collect franchise fees on ROW users, in particular cable operators, and will provide examples of franchise language that municipalities may consider using when negotiating new agreements with ROW users.

HISTORY OF CABLE TELEVISION FRANCHISE FEES

Prior to adoption of the 1984 Cable Act the FCC regulated franchise fees under rules promulgated in 1972. Under those rules the FCC limited franchise fees to no more than three percent of an operator's gross revenues. Franchising authorities were permitted to seek a waiver from the FCC to increase fees between three and five percent of gross revenues if the franchising authority could

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[3] *In the Matter of Acceleration of Broadband Deployment: Expanding the Reach and Reducing the Cost of Broadband Deployment by Improving Policies Regarding Public Rights of Way and Wireless Facilities Siting*, FCC 11-51, WC Docket No. 11-59, Notice of Inquiry (April 7, 2011), ¶ ¶ 16-20, "Reasonableness of Charges" and ¶ ¶ 21-23 "Qualitative Information".

demonstrate excessive regulatory costs to be incurred. *47 C.F.R. § 76.31 (1983)*. With the adoption of the 1984 Cable Act franchise fees were capped at five percent of an operator's gross revenues derived in any 12 month period. *47 U.S.C. § 542*. The Cable Act also limited the authority of the FCC to regulate both the amount of franchise fees and the use of those fees by franchising authorities. *47 U.S.C. § 542(i)*.

The Cable Act defines "franchise fees" at 47 U.S.C. § 542(g) as follows:

> *(1) the term "franchise fee" includes any tax, fee, or assessment of any kind imposed by a franchising authority or other governmental entity on a cable operator or cable subscriber, or both, solely because of their status as such;*
>
> *(2) the term "franchise fee" does not include:*
>
> > *(A) any tax, fee, or assessment of general applicability (including any such tax, fee, or assessment imposed on both utilities and cable operators or their services but not including a tax, fee, or assessment which is unduly discriminatory against cable operators or cable subscribers);*
> >
> > *(B) in the case of any franchise in effect on October 30, 1984, payments which are required by the franchise to be made by the cable operator during the term of such franchise for, or in support of the use of, public, educational, or governmental access facilities;*
> >
> > *(C) in the case of any franchise granted after October 30, 1984, capital costs which are required by the franchise to be incurred by the cable operator for public, educational, or governmental access facilities;*
> >
> > *(D) requirements or charges incidental to the awarding or enforcing of the franchise, including payments for bonds, security funds, letters of credit, insurance, indemnification, penalties, or liquidated damages; or*
> >
> > *(E) any fee imposed under title 17.*

While the Cable Act defines "franchise fee," the Act does not provide an express definition for "gross revenues" on which the franchise fee is based. Most of the disputes regarding franchise fees involve the definition of gross revenues, particularly whether an operator can properly exclude certain revenue from the imposition of a franchise fee.

HOW SHOULD GROSS REVENUES BE DEFINED IN A CABLE FRANCHISE?

A franchise provision establishing a fee should specify the amount of the fee, the method for calculating it, the frequency of payment, and any interest or penalties for late payments. Moreover, the cable operator should be required to furnish information to support its fee payment and the franchising authority should insist on the right to review and inspect the cable operator's financial records to verify the accuracy of franchise fee payments. Of these issues the topic most frequently contested between cable operators and franchising authorities is the definition of "gross revenues." Cable operators often seek to limit the scope of the definition so as to reduce the total amount of franchise fees to be remitted to the franchising authority. As referenced earlier, the Cable Act provides no express definition for gross revenues although historically the parties have generally agreed that any and all revenue derived from the provision of cable service within the city should be considered gross revenues.

Below is a sample definition for gross revenues which addresses many of the key revenue sources which franchising authorities should focus on to ensure that all revenue and consideration is included by the operator when calculating franchise fees.

> *"Gross Revenue" means any and all revenue billed (whether or not received) or derived directly or indirectly by Grantee, its affiliates, subsidiaries, parent, or any entity in which Grantee has a financial interest from the operation of its Cable System within the City including, but not limited to, 1) all Cable Service fees, 2) Franchise Fees, 3) late fees, returned check charges, collection agency charges, 4) Installation and reconnection fees, 5) fee payments or other consideration earned (whether or not received) by the Grantee from programmers for carriage of Cable Services or marketing support in connection with the Cable Services on the Cable System, 6) upgrade and downgrade fees, 7) advertising revenue with no deduction or offset for internal commissions earned by employees of Grantee or its affiliates, subsidiaries, parent, or any entity in which Grantee has a financial interest, and external commissions earned by advertising agencies/representation firms/brokers/etc. regardless of whether or not such commissions are withheld from remittances to the Grantee, 8) home shopping commissions, 9) Converter and remote*

control rental fees, 10) Lockout Device fees, 11) guides, and 12) production charges. The term Gross Revenue shall not include bad debts or any taxes on Services furnished by Grantee imposed upon Subscribers by any municipality, state, or other governmental unit and collected by Grantee for such governmental unit. City and Grantee acknowledge and agree that Grantee will maintain its books and records in accordance with generally accepted accounting principles (GAAP).

SHOULD GAAP BE INCLUDED IN GROSS REVENUES DEFINITION?

Nothing in the Cable Act, 47 U.S.C. § 542, references "Generally Accepted Accounting Principles" ("GAAP"). Over the last five years the cable industry has uniformly begun to request the inclusion of GAAP in the definition of gross revenues. The industry has also been successful in requiring this reference in many state statutes where state imposed franchise obligations set the franchise fee and define gross revenues. There are a number of reasons why franchising authorities should avoid the inclusion of GAAP in a definition of gross revenues. The only exception would be a concluding sentence which acknowledges that the operator may "maintain their books and records" in accordance with GAAP.

GAAP should not be included as part of the definition of gross revenues because it is an ever changing set of standards that do not speak to the calculation of "gross revenues" or "cable services" but rather to accounting practices dictating how companies should maintain their books and records. GAAP are subject to current events (2008 financial crisis, Enron debacle) and political changes and therefore create uncertainty when included within a definition of gross revenues that may sit in a contract extending for 10 to 15 years.

In addition, GAAP is not a purely objective set of standards but rather is subject to interpretation. In certain cases operators may attempt to use vague references to GAAP to circumvent requirements to pay franchise fees on various revenue categories. This is particularly true with respect to revenue sources that a cable operator may derive from advertising, marketing support, bartered advertising exchanges, launch fees and other non-subscriber revenue. As the industry evolves and changes in years to come, it is difficult to estimate exactly how much revenue the industry may derive from these non-subscriber sources and therefore it is prudent to maintain maximum flexibility in the contractual definition of gross revenues and exclude references which may work to the detriment of the franchising authority.

HOW SHOULD BUNDLED REVENUES BE TREATED?

In today's marketplace many communications providers are offering a triple play of services to consumers. For $120 a consumer may buy unlimited voice (telephone service), broadband service and a package of video/cable services. In the marketing materials provided by the operator the $120 cost may not break down the fees attributable to each of these three communications services. The question then becomes what portion of the $120 cost is subject to the 5% franchise fee? Will the operator simply apply one-third of the revenue for each of the three services offered or will there be a more significant discount for cable services which may work to the detriment of the municipality? What would prevent a cable operator from charging $50 for broadband, $50 for telephone but only $20 for cable services thus resulting in a significant reduction in the revenue on which the 5% franchise fee must be calculated.

In order to address this issue franchising authorities should at the time of franchise renewal include language within the franchise to prevent an operator from disproportionately allocating revenue to broadband and telecommunications services. In fact, several states that have adopted statewide franchising requirements impose language to clarify how bundled services should be addressed. In California where the state adopted the Digital Infrastructure and Video Competition Act of 2006 (DIVCA), state law now provides:

> *In the case of a video service that may be bundled or integrated functionally with other services, capabilities, or applications, the state franchise fee shall be applied only to the gross revenue as defined in subdivision (d), attributable to the deal service. Whether holder of a state franchise or any affiliate bundles, integrates, ties, or combines video services with non-video services creating a bundled package, so that subscribers may pay a single fee for more than one class of service or receive a discount on video services, gross revenues shall be determined based on an equal allocation of the package discount, that is, the total price of the individual classes of service that advertise rates compared to the package price, among all classes of service comprising the package. The fact that the holder of a state franchise offers a bundle package shall not be deemed a promotional activity. If the holder of a state franchise does not offer any component of the bundled package separately, the holder of a state franchise shall declare a stated retail value for each component based on reasonable comparable prices for the product or service for the purpose of determining franchise fees based on the package discount described above.*

Similar language should be included in a local franchise to prevent the operator from discounting cable service fees in a bundled package to avoid the payment of franchise fees to the franchising authority.

CAN CITIES COLLECT FRANCHISE FEES ON CABLE MODEM REVENUE?

Prior to March of 2002 cable operators routinely included revenue from cable modem service in franchise fee payments to municipalities. However in the spring of 2002, the FCC issued a Declaratory Ruling classifying cable modem service as an information service. As a result, cable modem service was subject solely to regulation at the federal level. Cable operators immediately stopped including cable modem revenue in franchise fee payments and several municipalities initiated litigation based on a variety of franchise requirements. These cases were largely unsuccessful and in the meantime the FCC's Declaratory Ruling had been challenged and reviewed by the Ninth Circuit.

On June 27, 2005, the United States Supreme Court held that the FCC was correct in classifying cable modem service as an "information service." In a 6-3 decision, authored by Justice Thomas, the Supreme Court held that the FCC was entitled to deference and made a "reasonable policy choice" in classifying cable modem service as an information service with no cable or telecommunications component. The case, *National Cable Telecommunications Association v. Brand X*, 125 S. Ct. 2688 (2005) overturned the Ninth Circuit's decision in *Brand X v. FCC*.

As mentioned above, the cable industry had been abiding by the FCC's Declaratory Ruling for the past several years and therefore neither consumers nor municipalities have noticed any significant change as a result of this decision. Cable modem service remains free from state and local regulation because of its classification as solely an information service.

The case represents a victory for the FCC which originally issued a Declaratory Ruling in March of 2002 classifying cable modem service as an information service only. Prior to that time municipalities had been collecting franchise fees on cable modem service revenue and some municipalities had attempted to require cable operators to provide access to unaffiliated Internet service providers (ISPs). Following the FCC's Declaratory Ruling several ISPs and numerous municipalities appealed the ruling which was ultimately heard by the Ninth Circuit. The Ninth Circuit concluded that cable modem service was not only an information service but included a telecommunications component. Had the Ninth Circuit decision been upheld cable operators would have been subject to common carrier regulation with respect to cable modem service.

The Supreme Court remanded the case to the Ninth Circuit and the Ninth Circuit will likely vacate its earlier decision and affirm the FCC's Declaratory Ruling ending the litigation. The next battle regarding broadband services will occur back at the FCC where a rulemaking proceeding is underway to determine the future of universal service funding, regulatory parity between cable modem service and DSL service, as well as customer service issues.

IMPOSITION OF A FRANCHISE FEE ON FRANCHISE FEE REVENUE

In 1995, the FCC's Cable Services Bureau ("Bureau") issued an important decision regarding franchise fee payments involving the City of Baltimore, Maryland. In Re United Artists Cable of Baltimore, Order DA 95-737, 10 F.C.C. Rcd. 7250 (C.S.B. 1995). In this decision the Bureau held that franchise fees were not revenues derived from the cable operator and therefore should not be included in the calculation of an operator's gross revenues. Shortly thereafter the FCC confirmed the Bureau's decision. See United Artists Cable, 11 F.C.C. Rcd. 18158 (1995).

The case was appealed to the Fifth Circuit and in 1997 the Fifth Circuit invalidated the FCC's Order holding that "even if franchise fees were treated as a tax they would still be treated as a normal expense of doing business once the tax was imposed directly upon the subscriber." The fact that cable operators have the right to identify the costs of government regulation on subscriber bills "does not, however, transform a cost imposed on cable operators into a cost imposed on cable subscribers….There is no plausible basis to conclude that cable operators are acting as collection agents on behalf of franchising authorities…Therefore, all money collected from subscribers, including funds used to pay franchise fees, must be included in a cable operator's gross revenue." See Dallas v. FCC, 118 F.3d 393 (1997).

While the Dallas decision was a victory for cities, implementation of the decision has been inconsistent throughout the country. In some cases, cable operators immediately changed their calculation of franchise fees to come into compliance with the Dallas decision. In other cases, cable operators sent out correspondence to franchising authorities seeking a waiver from compliance with the decision. In many other cases, cable operators have still not brought their billing systems into compliance.

WHO PAYS FRANCHISE FEE ON NON-SUBSCRIBER REVENUES?

In October of 2001, the FCC issued an order (16 F.C.C. Rcd. 18192 (Oct. 4, 2001)) involving the City of Pasadena, California ("Pasadena Order") which permitted cable operators to pass-through franchise fees to subscribers on cable television bills based on gross revenues that encompass "non-subscriber" revenue. Specifically, this non-subscriber revenue included income generated by advertising sales and home shopping commissions. As a result of the Pasadena Order many cable operators around the country increased franchise fees on subscribers' bills by .25% or more.

A number of local franchising authorities around the country, including a group of Texas franchising authorities and the National Association of Telecommunications Officers and Advisers petitioned the Fifth Circuit for review of the Pasadena Order. On March 27, 2003, the Fifth Circuit denied the petition for review on the grounds that the FCC had acted within its broad discretion and not in a manner that was arbitrary, capricious or manifestly contrary to the statute in question. See Texas Coalition of Cities for Utility Issues v. FCC, 324 F. 3d 802 (5th Cir. March 27, 2003).

The cities had argued that the Pasadena Order should be reversed because it conflicts with two particular provisions of the Cable Act, 47 U.S.C. §§ 542 and 543. In particular, the cities contended that where the franchise fee is based on the percentage of the cable operator's gross revenue, only the portion of that fee attributable to revenue from the subscribers may be passed through to subscribers. The cities argued that the Pasadena Order permitted an improper shifting of costs on to subscribers and that each class of the cable operator's customers should bear a proportionate amount of the franchise fee (i.e., the portion of the franchise fee attributable to advertising revenue should be passed through to advertisers). The Fifth Circuit concluded that whether or not the court may have interpreted the statutes differently the FCC's decision is entitled to deference and its order is not arbitrary and capricious.

The practical result for franchising authorities across the country is that cable operators can pass-through as a separate line item on subscribers' bills all franchise fees due and owing the franchising authority. These franchise fees may include non-subscriber revenues, including home shopping and advertising revenues. In other words, cable operators are permitted to reap the benefits of growth in non-subscription revenue while subscribers must bear the financial burden of increased franchise fees.

By way of example, if a cable operator sells $100 worth of advertising to a local business to provide commercial spots on the cable system many franchises require the cable operator to pay a five percent franchise fee on that revenue. Prior to the Pasadena Order in 2001 cable operators paid the applicable $5 franchise fee on the $100 of revenue and/or assessed the $5 fee to the advertiser. Under the Pasadena Order this $5 franchise fee is now spread over all subscribers in that jurisdiction resulting in an increase (average increase from Pasadena case is approximately .25% per month) in the total franchise fee paid by a subscriber. In essence, the more advertising a subscriber watches, the higher the franchise fee on their bill.

The Fifth Circuit decision has not resulted in any reduction in franchise fee payments to franchising authorities although subscribers must now bear the burden of additional franchise fee payments even as cable operators increase non-subscription revenue.

CAN CITIES OBTAIN BENEFITS BEYOND THE FIVE PERCENT FRANCHISE FEE?

Many franchise agreements include additional consideration provided by cable operators in the form of in-kind payments or services. These may include providing free wiring and cable service to local schools, equipment, studios and related support for local public, educational and governmental ("PEG") programming, institutional network connections and related consideration. The question is whether these in-kind contributions are permissible under the Cable Act's five percent cap on franchise fees.

By way of example, franchise negotiations often focus on the appropriate level of support to be provided for PEG programming. The Cable Act provides that for franchises in effect prior to 1984 franchising authorities may continue to enforce obligations for both capital and operational support of PEG access channels over and above the five percent cap on franchise fees. However, for franchises granted after 1984 the Cable Act limits franchising authorities' ability to seek additional in-kind support. In particular, in order to receive consideration over and above the five percent cap on franchise fees a franchising authority must ensure that in-kind benefits are not considered a "franchise fee" as defined in 47 U.S.C. § 542(g). One of the exceptions noted in 542 (g) relates to "capital costs which are required by the franchise to be incurred by the cable operator for public, educational or governmental access facilities." Franchising authorities have generally interpreted this to mean equipment and facilities related to the provision of PEG programming. The cable industry has often argued that it is narrower and relates solely to the capital costs related to the construction of a studio facility.

In 1999, the FCC's Cable Bureau responded to a letter from the City of Bowie, Maryland regarding franchise fee calculations and PEG access channel costs. (14 F.C.C. Rcd. 7674 (May 18, 1999)). At issue was whether PEG access equipment costs, salaries and training costs were subject to the five percent franchise fee cap. The Cable Bureau responded that only capital costs for construction of PEG access facilities should be excluded from the five percent cap. After pressure from franchising authorities the Cable Bureau issued a clarification stating that the legislative history of the Cable Act referred to franchise fees only as "monetary payments" that do not include any "franchise requirements for the provision of services, facilities or equipment." However, at least one court has held that a cable operator cannot be required to waive the five percent cap on franchise fees required under the Cable Act. See Cable TV Fund 14-1 Ltd. v. City of Naperville, No. 96 C 5962, 1997 U.S. Dist. LEXIS 11511(N.D. Ill. July 29, 1997).

On December 20, 2006, the FCC adopted an Order in Docket No. 05-311[4] which further addressed how franchise fees can be imposed under the Cable Act. The Order addresses four issues regarding franchise fee payments.

1. Franchise fee revenue base. The Order reiterates the FCC's prior position that cable operators are not required to pay franchise fees on revenues from non-cable services, such as Internet access services and broadband data services.

2. Charges incidental to the award of a franchise. The Order attempts to limit "incidental charges" to the list prescribed at 47 U.S.C. § 542(g)(2)(D). This list includes payments for bonds, security funds, letters of credit, insurance, indemnification, penalties or liquidated damages. These "incidental" requirements may be assessed by an LFA without counting toward the five percent (5%) franchise fee cap. The FCC goes on to provide examples of fees which are not incidental including: a) application or processing fees that exceed the reasonable cost of processing an application; b) acceptance fees; c) free or discounted services provided to an LFA; d) requirements to lease or purchase equipment from a franchising authority at prices higher than market value, and; e) in-kind payments.

3. Classification of in-kind payments. In-kind payments are not clarified in the Order, although examples of impermissible in-kind payments include municipal programs for libraries, recreation

[4] Report and Order and Further Notice of Proposed Rulemaking, Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, 22 FCC Rcd 5101 (March 5, 2007) ("Order")

departments, detention centers or other payments not related to PEG access.

4. Contributions in support of PEG services and equipment. The Order attempts to distinguish between "capital" and "operational" costs as specified in 47 U.S.C. § 542 (g)(2)(C). Generally, LFAs have understood that capital costs may be negotiated in a franchise above the five percent franchise fee cap. However, operational costs such as salaries for employees are generally not excluded from the five percent cap. Within the Order the FCC references capital costs as payments collected "only for the cost of building PEG facilities." The Order also provides that "capital costs refer to those costs incurred in or associated with the construction of PEG access facilities."

The FCC also concluded "that the non-capital costs of PEG requirements must be offset" from the Incumbent's franchise fee payments. The FCC attempted to draw a line between capital costs and operational costs in support of PEG. The FCC concluded in the Order that "capital costs refer to those costs incurred in or associated with the construction of PEG access facilities." In its brief before the Sixth Circuit, the FCC clarified that purchasing equipment used to provide PEG access may well be a capital cost as opposed to "salaries and training" which the FCC would consider "payments in support of the use of PEG access facilities" and therefore should counted toward the five percent franchise fee cap.

WHAT SHOULD A FRANCHISING AUTHORITY DO TO VERIFY THE ACCURACY OF FRANCHISE FEE PAYMENTS?

A franchise fee payment audit or review may be necessary to ensure that the cable operator's past performance under the existing franchise has been satisfactory and to uncover any underpayments that may have occurred over the years.

An audit or review is performed by analyzing information obtained from a franchising authority and its cable operator. During an audit/review the following tasks are completed:

1. Verification of revenues.
2. Variance analysis.
3. Verify mathematical accuracy.
4. Review excluded revenues.

5. Customer coding verification.

6. Method of verification.

7. Computing any applicable underpayment.

8. Analyzing new sources of revenue.

The following is an initial list of documents generally requested of a cable operator necessary to conduct a review of the cable operator's financial records:

1. Detailed list of revenues, by month, collected from subscribers during the desk review period.

2. Schedule(s) of the calculation of the subscriber franchise fees as used to determine the amounts remitted to the municipality during the desk review period.

3. Schedule(s) of the calculation of and documentation for any non-subscriber franchise fees incurred during the desk review period.

4. Copies of financial statements or general ledger, preferably audited, for the desk review period.

5. Schedule(s) showing detailed descriptions of Other Revenues on the general ledger or financial statements and the calculation of franchise fees, if any, related thereto during the desk review period.

6. Schedule(s) detailing bad debt expense and write-offs related to franchise fees and subscriber revenue during the desk review period.

7. Schedule(s) detailing franchise fee remittances to the municipality during the desk review period.

The above list is an initial request for information with respect to the franchise fee arrangement between the cable operator and a community. Additional information is often requested from a cable operator upon review of the initial response.

CAN AN OPERATOR REQUIRE A NONDISCLOSURE AGREEMENT?

Absent language in a franchise that clarifies how confidential information shall be handled during an audit or review of gross revenues, many cable operators have begun to require Non-Disclosure Agreements ("NDAs") to be executed by both the franchising authority and their auditor. In many cases these NDAs are extraordinarily burdensome and often prevent cities from securing the services of accounting firms because the accounting firms simply cannot sign the NDA and assume the risk imposed under the NDA.

Among the problems with these NDAs are the fact that the accounting firm may be held liable for consequential damages should their report reveal any confidential information that the operator deems is detrimental to its business. Faced with the prospect of uncapped, incidental and consequential damages over and above the fee for services obtained by the accounting firm, the risk is simply too high for many accounting firms to undertake the engagement. Particularly considering that their client is a public entity that generally must maintain many documents under state imposed sunshine statutes. In addition, the operator providing NDAs often prevent any disclosure of confidential information making it virtually impossible for the creation of a report that will accurately document any underpaid franchise fees. Given that such a report must ultimately be reviewed by a city manager and elected officials, maintaining confidentiality or a trade secret designation is difficult, if not impossible.

Franchising authorities should address this issue in a franchise agreement by either clarifying how confidential information shall be treated and that no NDA will be required at the time of the conduct of an audit or, in the alternative, include an agreed upon NDA as an exhibit to the franchise. By including an agreed upon NDA, the city can negotiate acceptable provisions that would limit the exposure to an accounting firm and would clarify how information can be communicated in a final report. Moreover, the NDA can address how information will be provided by the operator or whether the city's accountant may be forced to travel to an alternative location to obtain the information. By addressing these issues up front, the city can avoid lengthy delays and additional expense in the auditing process resulting from efforts to reach agreement on an acceptable NDA.

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