The Price of Competition?

The Contracts Clause, Competitive Cable Franchises, and Local Authority to Adopt Cable Customer Service Regulations

— *by Matthew C. Ames* —



Cable television subscribers in hundreds of communities across the United States now have a choice of cable provider, as Verizon rolls out its state-of-the-art fiber network, offering voice, video and Internet service. Verizon has obtained franchises to provide cable service in those jurisdictions, from either the state or local government. Although competitive alternatives have existed for some time in a few communities, never before has a company with Verizon's reputation and resources committed itself to entering the cable marketplace. Prospective subscribers have responded enthusiastically, and local franchising authorities have worked hard to accommodate the public demand for competition.

Enthusiasm tends to fade, however, and once Verizon is no longer the exciting new prospect but an incumbent cable company, the public's perspective may change. Americans have a love-hate relationship with cable television: we love the product, but we hate the provider, especially when there is a problem with our service. Delivering cable television service is a greater technical challenge than providing telephone service, and cable subscribers have high expectations. As Verizon's cable business grows, we can anticipate that the company will face new problems, and local governments may face pressure to help frustrated subscribers.

Verizon's Agreements Seek To Restrict Local Authority

Verizon's entry has changed more than the competitive landscape. Municipal cable franchises have traditionally stated that the granting entity retains its police powers.[1] Verizon, however, has very successfully used public demand for its service to persuade franchising authorities to accept franchise language intended to protect the company against the future exercise of local police powers. For example, Verizon's agreement with the City of Hampton, Virginia, states:

> Nothing in the Franchise shall be construed to prohibit the reasonable, necessary and lawful exercise of City's police powers. However, if the reasonable, necessary and lawful exercise of City's police power results in any material alteration of the terms and conditions of this Franchise, then the parties shall modify this Franchise to the mutual satisfaction of both parties to ameliorate the negative effects on Verizon of the material alteration. Any modifications shall be in writing. If the parties cannot reach agreement on the above-referenced modification to the Franchise, then Verizon may terminate this Agreement without further obligation to the City or, if the parties mutually agree, the matter may be submitted to binding arbitration in accordance with the commercial arbitration rules of the American Arbitration Association.[2]

This is a typical formulation, but some franchises go further. For example, an Oregon franchise allows Verizon to refer such disputes to binding arbitration without the franchising authority's consent.[3]

Similar provisions now appear in hundreds of Verizon franchises, and may soon become common in other agreements as incumbent cable operators insist on comparable treatment. The potential effect of these provisions is magnified by Verizon's practice of including standard customer service terms in its franchises. Future efforts to address customer service issues may conflict with these franchise terms.[4] Thus, Verizon's new agreements raise many questions: Are provisions like Hampton's Section 2.9 enforceable, or are they void under the principle that a local government cannot bargain away its police powers? If enforceable, what is their effect if a local government later adopts a customer service ordinance or other legislation addressing the subject matter of the franchise?

Before examining the effects of Section 2.9 and comparable provisions, it is helpful to understand how the courts treat local legislation that conflicts with a private party's obligations under a franchise. This question is governed by the "Contracts Clause" of the Constitution.

The Effect of the Contracts Clause

On its face, the Contracts Clause is absolute: "No state shall . . . pass any . . . law impairing the obligation of contracts . . . ."[5] The U.S. Supreme Court, however, has recognized that the states must retain the power to protect their citizens, and private parties cannot be allowed to exempt themselves from generally applicable law by entering into private contracts.[6] In effect, every contract contains an implied reservation of the police power.[7] In a series of decisions, the Supreme Court has developed a three-part test for determining if a state or local enactment goes too far.[8]

In essence, the courts will ask: (1) whether the legislation substantially impairs a contract; (2) whether the legislation addresses a significant and legitimate public purpose; and (3) whether the means chosen are reasonable. Most courts will also ask whether the means were "necessary," but the Supreme Court's decisions are not entirely consistent, so some lower courts have adopted a slightly different test.[9] In assessing reasonableness and necessity, the courts ordinarily defer to the judgment of the legislative body, but if the legislation affects a financial obligation of a state or local government as a contracting party, the courts will examine the law more closely.[10]

One court has discussed the Contracts Clause in connection with a local cable ordinance. In *Storer Cable Communications v. City of Montgomery*,[11] the city had granted two cable franchises, and subsequently adopted an ordinance aimed at

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preventing anti-competitive behavior by the operators. Among the issues raised in summary judgment motions was whether the ordinance violated the Contracts Clause. The court described the Supreme Court's test, but concluded that it could not apply the test using the factual record it had at that stage. This appears to be the only reported decision involving the application of the Contracts Clause to a cable regulatory ordinance.

It bears noting that the three-part test applies to all impairments of contracts, whether they result from an exercise of the police power, or some other governmental power, such as the right of eminent domain. The traditional doctrine of reserved powers distinguished between those powers which are always reserved, such as the police power, and powers that can be limited by contract, such as the future exercise of the taxing and spending powers. In *United States Trust Co. of New York v. New Jersey*,[12] however, the Supreme Court suggested that the outcome of a case may turn on the nature of the obligation, rather than the nature of the power. That is, the Court was less concerned with whether the state was exercising its police power, its spending power, or the right of eminent domain, than with whether it was abrogating a financial commitment or some other type of obligation.[13] Thus, although it remains true that the courts will give less deference to legislation that modifies a state or local government's own contracts, the exact nature of the obligation may be the more important consideration, at least in the case of litigation under the Contracts Clause. Indeed, the original purpose of the Contracts Clause was to protect creditors against efforts by the states to repudiate their debts.[14] Some cases suggest broadly that any exercise of the police power that affects a government entity's own contracts is entitled to less deference, but, when considered carefully, the degree of deference may depend more on whether the legislation favors the narrow institutional interests of the legislating entity, rather than the broader public interest.

In any event, it is clear that if a local government adopts legislation that imposes new financial obligations on a contracting party, or limits the locality's financial obligations under a contract, the courts will give that legislation careful scrutiny. The courts will also look askance at any exercise of the police power that gives the government an advantage when acting in its proprietary capacity, or favors one market competitor over another.[15]

Some of the other factors considered at various stages of the analysis in recent Contracts Clause decisions include: (1) whether an ordinance addressed harms that existed at the time the franchise was granted and were "explicitly anticipated" at that time;[16] (2) whether legislation was aimed at a "broad, generalized economic or social problem;"[17] (3) whether an "unprecedented emergency" existed[18] (although the Supreme Court has said that this need not be a factor[19]); (4) whether the subject matter of the contract has traditionally been regulated;[20] (5) whether the right abridged was one that had induced the parties to enter into the contract in the first place;[21] and (6) whether the new legislation was enforced in a manner that actually altered the behavior of a party.[22]

It is difficult to predict whether a new customer service ordinance would survive a Contracts Clause challenge. The factors identified in the cases cut both ways. For example, a customer service ordinance that alters the terms of a franchise agreement broadly benefits those members of the public who subscribe to cable service, rather than the pecuniary interest of the municipality. Furthermore, regulation of customer service is common and explicitly permitted by federal law. On the other hand, Verizon could argue that the potential harms addressed by such an ordinance were known when the franchise was granted. Verizon also would surely argue that the customer service terms of the franchise were fundamental terms of the agreement because the company was concerned with preventing future regulation, and it would not have agreed to accept the franchise if it had not been able to specify those terms in the franchise.

Thus, should local governments seek to alter the terms of Verizon's customer service commitments in the future, they may face novel arguments and uncertainty about the outcome. The company may not object to minor changes, but it will very likely object to a wholesale revision of its obligations, and to new obligations that impose significant compliance costs.

Enforceability of Franchise Provisions Limiting Police Powers

Section 2.9 of the Hampton franchise mentioned earlier purports to preserve the City's police powers, but then appears to restrict the free exercise of those powers. The franchise does this both by incorporating a specific test for evaluating the City's actions, and by giving the company procedural rights in the event an ordinance passes the test. Section 2.9 and comparable provisions thus raise the questions of whether they are themselves enforceable, and, if so, how they might be applied.

There are thousands of reported decisions that contain some formulation of the reserved powers doctrine, the rule that "a local government cannot contract away its police power."[23] The doctrine itself is generally stated in broad and absolute terms, but the trend in recent reported decisions seems to be to read the doctrine narrowly and enforce contractual commitments.[24]

This is not to say that the doctrine has no force. For example, in *City of Las Vegas v. Cragin Indus., Inc.*,[25] Las Vegas had entered into an agreement with an electric utility, in which the utility agreed to address aesthetic concerns in a particular area by increasing the height of certain street poles, and placing its electric lines on those poles. The City, however, had earlier adopted an ordinance requiring that wiring be placed underground. When the agreement was challenged by the affected property owners, the court ruled that the undergrounding ordinance was binding on the City, and could not be waived or repealed by contract.

Nevertheless, the effect of the doctrine is generally narrower than it appears when stated in the abstract. The doctrine is probably best construed as only affecting contracts that amount to a municipality's "surrender" or "abnegation" of authority to act in a matter that is properly considered exclusively a municipal function.[26] Furthermore, there

is authority suggesting that only the offending provision is void, especially if the contract contains a severability clause.[27]

For this reason, it is very difficult to generalize about the validity of provisions like Section 2.9. The example of a cable customer service ordinance helps illustrate this. As noted above, federal law expressly permits local governments to adopt such ordinances, and they are common, although not universal. State law varies, since some states regulate customer service to one degree or another at the state level, and Dillon's Rule[28] and the scope of home rule may also be factors. Nevertheless, it seems fair to say that a cable customer service ordinance would fall comfortably under the rubric of "public health, safety and welfare," and thus, be deemed a valid exercise of the police power. Such an ordinance might require a cable operator to answer telephone calls from subscribers within 30 seconds, or respond to requests for repairs in case of a service outage within 24 hours, or respond to subscriber inquiries regarding their bills within ten days, for example. Verizon, however, has developed its own standards for such matters, which are expressly incorporated into its franchise agreements.

What would be the effect of Section 2.9 if a community was to adopt a comprehensive customer service ordinance after granting a franchise, an ordinance that imposed stricter standards than the franchise agreement? Section 2.9 creates a substantive right, because it arguably permits the company to ignore any exercise of the police power that is not "reasonable," "necessary," or "lawful." Thus, the company might choose not to comply, forcing the city to take enforcement action. But Verizon already has the right to challenge any application of the police power under the Contracts Clause, so is Section 2.9 a further restriction? If it is, is it enforceable? Section 2.9's formulation essentially adopts the Supreme Court's Contracts Clause test as set out in *United States Trust Co.*, but what if the lower court considers reasonableness, but not necessity? In that case, one could argue that the city has agreed not to exercise its police powers in cases where it might otherwise do so, which suggests that the city may have bartered away its police powers. In that case, Section 2.9 might be invalid. On the other hand, if the franchise standard is effectively identical to the constitutional one, Verizon presumably has both a constitutional claim, and a breach of contract claim, for any violation of the Contracts Clause standard.[29]

Section 2.9 also says that, even if a challenged provision is reasonable, lawful, and necessary, the company has certain procedural rights. If the exercise of the police powers results in a "material" alteration of Verizon's obligations, the company is entitled to have the terms of its franchise changed to counteract any "negative" effect. In other words, if the City of Hampton exercises its police powers in a way that affects the franchise, the franchise is to be amended to eliminate that effect, even if the alteration does not violate the Contracts Clause. To put it yet another way, Section 2.9 is intended to immunize Verizon against the exercise of the City's police power. As written, however, the Hampton version of Section 2.9 is probably saved, because the City must consent to the modification of the franchise. If the parties cannot agree, Verizon can terminate the agreement, or, with the City's consent, the parties can agree to binding arbitration. But the City need not consent, leaving Verizon with the choice of termination, living with the provision, or suing the City, presumably on the grounds that the new ordinance violates the Contracts Clause. Thus, the Hampton version of Section 2.9 may not violate the reserved powers doctrine, but it may also be effectively unenforceable, if the City is willing to stand its ground.

The Oregon version of Section 2.9, however, does bring the reserved powers doctrine into play. This version effectively prohibits a city from exercising its police power because, if it does, it must relieve Verizon of the consequences of its action: Verizon may take disputes to binding arbitration without the city's consent. Whether such a term is enforceable under Oregon law is outside the scope of this article, but, in some states, binding arbitration might be held to violate the reserved powers doctrine.[30]

Conclusion

The new Verizon franchises will raise new and interesting questions, should communities decide that local regulation is required. An additional policy problem will also arise if customer service concerns become widespread: because of the varying language of the franchises and the differences in state law, some local governments may find that they cannot meet the needs of their residents. State legislation authorizing local action would itself raise Contracts Clause issues, and, therefore, may be insufficient. The only practical remedy may be federal legislation – or regulation by the Federal Communications Commission – that preempts restrictions on local power and restores the freedom of local governments to act in the best interests of cable subscribers.

Notes

1. *See, e.g.*, Telesat Cablevision, Inc. v. City of Riviera Beach, 773 F. Supp. 383, 409 (S.D. Fla. 1991) (quoting reservation of police powers in franchise).
2 . HAMPTON, VA, ORDINANCE 08-0309 (July 22, 2008), § 2.9 (hereinafter "Section 2.9").
3. Franchise Agreement between Metropolitan Area Communications Commission and Verizon Northwest Inc., § 2.9 (May 25, 2007).
4. Indeed, many local governments have adopted cable regulatory ordinances for its purpose, and federal law expressly protects that right. *See* 47 U.S.C. § 552 (West 2009). Verizon has obtained waivers of many of these ordinances, which itself raises legal questions.
5. U.S. CONST., art. I, § 10.
6. Allied Structural Steel v. Spannaus, 438 U.S. 234, 241 (1978).
7. Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 435 (1934).
8. Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411-413 (1983); Allied Structural Steel, 438 U.S. at 242-45; United States Trust Co. of New York v. New Jersey, 431 U.S. 1, 26 (1977).
9. Compare Blue Cross & Blue Shield of Michigan v. Milliken, 367 N.W.2d 1 (Mich. 1985) (reasonably related), with Massachusetts Cmty. Coll. Council v. Commonwealth of Massachusetts, 649 N.E.2d 708, 712 (Mass. 1995) (reasonable and necessary).
10. United States Trust Co., 431 U.S. at 25-26.
11. 806 F. Supp. 1518 (M.D. Ala. 1992).
12. 431 U.S. 1 (1977).
13. *Id.* at 24-25.

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to the risks that various options present, and provides municipalities with a roadmap for avoiding liability, if not litigation.

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14. Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470, 502-03 (1987).
15. *See, e.g.*, Texas Power & Light Co. v. City of Garland, 431 S.W.2d 511 (Tex. 1968); City of Tukwila v. City of Seattle, 414 P.2d 597 (Wash. 1966).
16. Southern Calif. Gas Co. v. City of Santa Ana, 336 F.3d 885, 896 (9th Cir. 2003).
17. AFSCME, Local 2957 v. City of Benton, 513 F.3d 874, 882 (8th Cir. 2008).
18. *Id.*
19. Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 412 (1983).
20. Chicago Bd. of Realtors, Inc. v. City of Chicago, 819 F.2d 732 (7th Cir. 1987).
21. Baltimore Teachers Union v. Mayor and City of Council of Baltimore, 6 F.3d 1012, 1017 (4th Cir. 1993).
22. United States v. County of Muskegon, 298 F.3d 569, 585 (6th Cir. 2002).
23. *See, e.g.*, Contributors to Penn. Hosp. v. City of Philadelphia, 245 U.S. 20 (1917) (eminent domain power cannot be surrendered by contract); Pub. Serv. Co. of Colo. v. City of Loveland, 245 P. 493 (Colo. 1926) (city officials lacked the authority to execute a disclaimer upon behalf of themselves or future city councils that would deprive them of the exercise of their eminent domain power); and Bd. of County Com'rs of Calvert County v. East Prince Frederick Corp., 559 A.2d 822 (Md. App. 1989) (County's policy requiring reserved sewage and water capacity to be used within two years or payment of minimum user fees did not offend the doctrine, as the County lacked the power to create sewer rights in perpetuity and effectively prevent the enactment of future laws to fit changed circumstances).
24. *See, e.g.*, Wheat Ridge Urban Renewal Auth. v. Cornerstone Group XXII, LLC, 176 P.3d 737, 742-44 (Colo. 2007) (agreement to exercise eminent domain enforceable).
25. 478 P.2d 585 (Nev. 1970).
26. Morrison Homes Corp. v. City of Pleasanton, 130 Cal. Rptr. 196, 202 (Cal. Ct. App. 1976).
27. Hudson v. City of Bossier City, 930 So.2d 881 (La. 2006).
28. City of Clinton v. Cedar Rapids & Mo. River R.R., 24 Iowa 455, 475 (Iowa 1868) (Dillon's Rule states that municipal corporations have only those powers that are expressly granted, those necessarily or fairly implied from expressly granted powers, and those that are essential and indispensable).
29. The Seventh Circuit has made the interesting point that if a contract allows a party to pursue a claim for breach of contract, there is actually no impairment of the contract. Horwitz-Matthews, Inc. v. City of Chicago, 78 F.3d 1248, 1250-51 (7th Cir. 1996). Under this rule, one could argue that the Hampton provision renders any Contracts Clause claim moot, because Verizon would retain the ability to sue for breach of contract under the same standards that would apply to a Contracts Clause claim.
30. *See* City of Covington v. Covington Lodge No. 1, Fraternal Order of Police, 622 S.W.2d 221 (Ky. 1981). ML

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plaintiff fell" at the time he broke his ankle. Nonetheless, the court held that the plaintiff failed to prove that the City was grossly negligent in the manner in which it handled the ploughing and/or sanding of the sidewalks. "All municipalities, especially large cities [,] have a monumental task to keep the public safe during all sorts of winter conditions," and the conditions at the time the plaintiff fell were a "unique situation."

The court dismissed the action, concluding with a request that the City not demand costs, as this "would only make the plaintiff's bad situation worse." ML

Ordinances

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4. Westport, CT, Retail Checkout Bags Ordinance (Sept. 5, 2008).
5. *Id.*
6. *Id.*
7. Maui County, HI., Ordinance Pertaining to Plastic Bag Reduction (July 14, 2008).
8. Austin, TX., Resolution No. 20070419-026 (Apr. 19, 2007).
9. *After a Year, Local Retailers Report Less Plastic Bag Usage*, Austin Business Journal, Nov. 18, 2008, at http://austin.bizjournals.com/austin/stories/2008/11/17/daily23.html.
10. Adam Lisberg, *Mayor Bloomberg Paints Grim Economic Picture for New York City 2009 Budget*, New York Daily News, Jan. 30, 2009, at http://www.nydailynews.com/ny_local/2009/01/30/2009-01-30_mayor_bloomberg_paints_grim_economic_pic.html.
11. Anne Thompson, *Paper or Plastic – What's the Greener Choice?* MSNBC.com, May 7, 2007, at http://www.msnbc.msn.com/id/18538484.
12. Joe Eskenazi, *The City's Politicos Made the Enviros Happy by Banning Plastic Bags, But Left Us With More Pollution and Cost*, SFWeekly.com, Jan. 07, 2009, at http://www.sfweekly.com/content/printVersion/1297386. See also, http://sfenvironment.org/downloads/library/2008_litter_audit.pdf.
13. Press Release, IKEA, *The Results are in ... over 92% of IKEA Customers Bagged the Plastic Bag!* (April 2, 2008) (on file with author).
14. Kathy Mulady, *$1280,625 to Fight 20-cent Bag Fee*, Seattle Post-Intellingencer, Sept. 11, 2008, at http://seattlepi.nwsource.com/local/378828_bags12.html. ML

Listserve

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