

CROWN MEDIA HOLDINGS INC
Form 10-Q
July 27, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2012

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____ .

Commission File Number: 000-30700

Crown Media Holdings, Inc.

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(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

84-1524410
(I.R.S. Employer Identification No.)

12700 Ventura Boulevard,

Suite 200

Studio City, California 91604

(Address of principal executive offices and Zip Code)

(818) 755-2400

(Registrant's telephone number, including Area Code)

(Former name, former address, and former fiscal year,

if changed since last report.)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer
(do not check if a smaller reporting company)

Smaller reporting company

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of July 23, 2012, the number of shares of Class A Common Stock, \$.01 par value outstanding was 359,675,936.

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In this Form 10-Q the terms *Crown Media Holdings* or the *Company*, refer to *Crown Media Holdings, Inc.* and, unless the context requires otherwise, subsidiaries of *Crown Media Holdings* that operate or have operated our businesses, including *Crown Media United States, LLC* (*Crown Media United States*). The term *Common Stock* refers to our *Class A Common Stock*.

The name *Hallmark* and other product or service names are trademarks or registered trademarks of entities owned by *Hallmark Cards, Incorporated* (*Hallmark Cards*).

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements (Unaudited)****CROWN MEDIA HOLDINGS, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except share and per share data)

	As of December 31, 2011	As of June 30, 2012
ASSETS		
Cash and cash equivalents	\$ 35,181	\$ 23,678
Accounts receivable, less allowance for doubtful accounts of \$181 and \$234, respectively	83,798	85,069
Program license fees	98,158	83,263
Prepaid program license fees	11,533	31,377
Deferred tax asset, net	14,200	12,300
Prepaid and other assets	1,174	2,259
Total current assets	244,044	237,946
Program license fees	152,806	151,120
Property and equipment, net	11,236	10,730
Deferred tax asset, net	221,800	209,162
Debt issuance costs, net	11,711	11,071
Prepaid and other assets	2,839	4,556
Goodwill, net	314,033	314,033
Total assets	\$ 958,469	\$ 938,618

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CROWN MEDIA HOLDINGS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

(continued)

	As of December 31, 2011	As of June 30, 2012
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES:		
Accounts payable and accrued liabilities	\$ 15,391	\$ 14,237
Audience deficiency reserve liability	10,256	9,896
License fees payable	135,768	107,261
Payables to Hallmark Cards affiliates	4,051	11,006
Interest payable	17,135	14,499
Current maturities of long-term debt	19,600	2,100
Total current liabilities	202,201	158,999
Accrued liabilities	16,667	19,921
License fees payable	8,737	14,827
Long-term debt, net of current maturities	487,368	486,456
Total liabilities	714,973	680,203
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY:		
Class A common stock, \$.01 par value; 500,000,000 shares authorized; 359,675,936 shares issued and outstanding as of December 31, 2011, and June 30, 2012, respectively	3,597	3,597
Paid-in capital	2,082,241	2,071,417
Accumulated deficit	(1,842,342)	(1,816,599)
Total stockholders equity	243,496	258,415
Total liabilities and stockholders equity	\$ 958,469	\$ 938,618

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**CROWN MEDIA HOLDINGS, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)**

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2012	2011	2012
Revenue:				
Advertising	\$ 57,686	\$ 65,482	\$ 113,290	\$ 128,468
Advertising by Hallmark Cards	228	1,035	358	1,911
Subscriber fees	18,132	19,860	35,881	39,658
Other revenue (including \$161 from Hallmark Cards for three and six months ended June 30, 2012)	104	363	216	477
Total revenue, net	76,150	86,740	149,745	170,514
Cost of Services:				
Programming costs				
Non-affiliates	35,860	33,809	67,586	67,256
Hallmark Cards affiliates	405	729	786	1,417
Other costs of services	2,941	3,668	5,893	6,737
Total cost of services	39,206	38,206	74,265	75,410
Selling, general and administrative expense (exclusive of depreciation and amortization expense shown separately below)				
	12,535	14,269	28,271	28,624
Marketing expense	543	739	893	1,239
Depreciation and amortization expense	367	348	752	696
Income from operations before interest and income tax expense	23,499	33,178	45,564	64,545
Interest expense	(1,535)	(11,431)	(3,330)	(23,204)
Income from operations before income tax (expense) benefit	21,964	21,747	42,234	41,341
Income tax (expense) benefit	(419)	(8,274)	43,408	(15,598)
Income before discontinued operations	21,545	13,473	85,642	25,743
Gain from sale of discontinued operations, net of tax	189		189	
Net income and comprehensive income	21,734	13,473	85,831	25,743
Income allocable to Preferred Shareholder	(9,683)		(26,277)	
Net income attributable to common stockholders	\$ 12,051	\$ 13,473	\$ 59,554	\$ 25,743
Weighted average number of common shares outstanding, basic and diluted				
	359,676	359,676	359,676	359,676
Income per common share before discontinued operations, basic and diluted	\$ 0.03	\$ 0.04	\$ 0.17	\$ 0.07
Gain per common share from discontinued operations, basic and diluted				
Net income per common share, basic and diluted	\$ 0.03	\$ 0.04	\$ 0.17	\$ 0.07

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**CROWN MEDIA HOLDINGS, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	Six Months Ended June 30,	
	2011	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 85,831	\$ 25,743
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of discontinued operations	(189)	
Depreciation and amortization	64,898	65,543
Provision for allowance for doubtful accounts	301	28
Income tax (benefit) expense	(43,408)	15,598
Stock-based compensation	46	155
Changes in operating assets and liabilities:		
Decrease (increase) in accounts receivable	8,388	(1,299)
Additions to program license fees	(87,584)	(44,927)
Increase in prepaid and other assets	(14,396)	(24,799)
(Decrease) increase in accounts payable, accrued and other liabilities	(11,425)	2,055
Decrease in interest payable	(50)	(2,800)
Increase (decrease) in license fees payable	18,363	(21,668)
Decrease in payables to Hallmark Cards affiliates	(6,645)	(5,678)
Net cash provided by operating activities	14,130	7,951
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(607)	(328)
Payments to buyer of international business	(94)	
Net cash used in investing activities	(701)	(328)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on the Term Loan		(18,550)
Principal payments on notes payable to HCC	(23,559)	
Dividends paid to Preferred Stockholder	(12,843)	
Principal payments on capital lease obligations	(518)	(576)
Net cash used in financing activities	(36,920)	(19,126)
Net decrease in cash and cash equivalents	(23,491)	(11,503)
Cash and cash equivalents, beginning of period	30,565	35,181
Cash and cash equivalents, end of period	\$ 7,074	\$ 23,678
Supplemental disclosure of cash and non-cash activities:		
Interest paid	\$ 2,187	\$ 25,007
Reduction of additional paid-in capital for tax transactions	\$ 9,975	\$ 10,824
Asset acquired through capital lease obligation	\$ 63	\$

See accompanying notes to unaudited condensed consolidated financial statements.

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CROWN MEDIA HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the Three and Six Months Ended June 30, 2011 and 2012

1. Business and Organization

Crown Media Holdings, through its wholly-owned subsidiary Crown Media United States, owns and operates pay television networks (collectively, the Networks or the networks) dedicated to high quality entertainment programming for adults and families, in the United States. The significant investor in the Company is H C Crown, LLC (HCC), a subsidiary of Hallmark Cards.

The Company's continuing operations are currently organized into one operating segment, the Networks.

On June 29, 2010, the Company consummated a series of recapitalization transactions in which approximately \$1.2 billion owed to HCC and Hallmark Cards was extinguished upon issuance of (i) the Term A Loan, the Term B Loan and Preferred Stock in the aggregate face amount of \$500 million and (ii) Common Stock (the Recapitalization). On July 14, 2011 the Company used the proceeds from a new \$210 million senior secured term loan (the Term Loan) and \$300 million of senior unsecured notes (the Notes) to repay the Term A Loan and the Term B Loan and redeem all of the outstanding Preferred Stock (collectively, the 2011 Refinancing).

2. Summary of Significant Accounting Policies and Estimates

Interim Financial Statements

In the opinion of management, the accompanying condensed consolidated balance sheets and related interim condensed consolidated statements of operations and cash flows include all adjustments, consisting of normal recurring items necessary for their fair presentation in conformity with accounting principles generally accepted in the United States. Interim results are not necessarily indicative of results for a full year. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes to those statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Basis of Presentation

The condensed consolidated financial statements include the accounts of Crown Media Holdings and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in accordance with generally accepted accounting principles requires the consideration of events or transactions that occur after the balance sheet date but before the financial statements are issued. Depending on the nature of the subsequent event, financial statement recognition or disclosure of the subsequent event is required.

Use of Estimates

The preparation of the accompanying consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions about future events. These estimates and the underlying assumptions affect the amounts of assets and liabilities reported, disclosures about contingent assets and liabilities, and reported amounts of revenues and expenses. Such estimates include the collectability of accounts receivable, the valuation of goodwill, intangible assets, and other long-lived assets, legal contingencies, indemnifications, and assumptions used in the calculation of income taxes and related valuation allowance, among others.

All of the estimates that are employed are based on management's best estimates and judgment. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including

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the current economic environment, which management believes to be reasonable under the circumstances. Management adjusts such estimates and assumptions when facts and circumstances dictate. Illiquid credit markets, volatile equity markets, and declines in consumer spending have combined to increase the uncertainty inherent in such estimates and assumptions. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes, if any, in those estimates resulting from continuing changes in the economic environment will be reflected in the financial statements in future periods.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based upon the Company's assessment of probable loss related to uncollectible accounts receivable. The Company uses a number of factors in determining the allowance including, among other things, collection trends. The Company's bad debt expense was \$129,000 and \$8,000 for the three months ended June 30, 2011 and 2012, respectively. The Company's bad debt expense was \$301,000 and \$28,000 for the six months ended June 30, 2011 and 2012, respectively.

Fair Value of Financial Instruments

Financial Accounting Standards Board (FASB) Accounting Standards Codification (the ASC) Topic 820, *Fair Value Measurements and Disclosures*, provides guidance which defines fair value, establishes a framework for measuring fair value and specifies disclosures about fair value measurements. We determine fair value as an exit price, representing the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The Company does not have balance sheet items carried at fair value on a recurring basis. Significant balance sheet items which are subject to non-recurring fair value measurements consist of goodwill and property and equipment.

Net Income per Share

Basic net income per share for each period is computed by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income per share for each period is computed by dividing net income attributable to common stockholders by the weighted average number of common shares plus potentially dilutive common shares outstanding except whenever any such effect would be antidilutive. Potential common shares consisted of incremental common shares issuable upon the exercise of stock options and common shares issuable upon conversion of the preferred stock.

Net income attributable to common stockholders for the three and six months ended June 30, 2011, reflects allocations in favor of preferred stockholders for (i) imputed preferred stock dividends for financial reporting purposes of \$839,000 and \$1.6 million, (ii) cumulative preferred stock dividends of \$6.4 million and \$12.8 million, and (iii) the potential participation in common stock dividends (equivalent to approximately 71.2 million shares of common stock) of \$2.4 million and \$11.8 million, respectively. Such considerations were not applicable to the three and six months ended June 30, 2012, because the preferred stock was redeemed by the Company in connection with the 2011 Refinancing.

Approximately 39,000 and 50,000 stock options for the three and six months ended June 30, 2011, respectively, and approximately 5,000 and 18,000 stock options for the three and six months ended June 30, 2012, respectively, have been excluded from the determination of diluted net income per share because the individual effect in each instance was antidilutive.

Concentration of Risk

Financial instruments, which potentially subject Crown Media Holdings to a concentration of credit risk, consist primarily of cash, cash equivalents and accounts receivable. Generally, Crown Media Holdings does not require collateral to secure receivables. Crown Media Holdings has no significant off-balance sheet financial instruments with risk of accounting losses.

Five of our distributors each accounted for more than 10% of our consolidated subscriber revenue for both the three months ended June 30, 2011 and 2012, and together accounted for a total of 83% and 84% of consolidated subscriber revenue during the three months ended June 30, 2011 and 2012, respectively. Three of our distributors

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each accounted for approximately 15% or more of our consolidated subscribers for the three months ended June 30, 2011 and 2012, respectively, and together accounted for 60% and 61% of our subscribers during the three months ended June 30, 2011 and 2012, respectively. The loss of one of these distributors could have a significant impact on the Company's operations.

Four of our distributors each accounted for more than 10% of our consolidated subscriber revenue for both the six months ended June 30, 2011 and 2012, and together accounted for a total of 74% and 75% of consolidated subscriber revenue during the six months ended June 30, 2011 and 2012, respectively. Three of our distributors each accounted for approximately 15% or more of our consolidated subscribers for the six months ended June 30, 2011 and 2012, respectively, and together accounted for 60% and 61% of our subscribers during the six months ended June 30, 2011 and 2012, respectively. The loss of one of these distributors could have a significant impact on the Company's operations.

Three of our programming content providers each accounted for more than 10% of our total license fee programming for both the six months ended June 30, 2011 and 2012, and together accounted for a total of 57% and 55% of the consolidated programming liability for the six months ended June 30, 2011 and 2012, respectively.

Recently Issued Accounting Pronouncements

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. ASU No. 2011-05 requires that all nonowner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements, eliminating the option to present other comprehensive income in the statement of changes in equity. Under either choice, items that are reclassified from other comprehensive income to net income are required to be presented on the face of the financial statements where the components of net income and the components of other comprehensive income are presented. This amendment is effective for the Company in 2012 and has been applied retrospectively. This amendment did not change the manner in which the Company presents comprehensive income, as the Company did not have comprehensive income during the periods presented.

In September 2011, the FASB issued ASU No. 2011-08, *Testing for Goodwill Impairment (Topic 350)*, (ASU 2011-08). ASU 2011-08 allows entities to first assess qualitatively whether it is necessary to perform the two-step goodwill impairment test. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting period is less than its carrying amount, the quantitative two-step goodwill impairment test is required. An entity has the unconditional option to bypass the qualitative assessment and proceed directly to performing the first step of the goodwill impairment test. The Company elected to adopt this accounting guidance at the beginning of its fourth quarter of 2011 on a prospective basis for goodwill impairment tests. The adoption of this standard did not have a material impact on its consolidated financial statements and footnote disclosures.

3. Program License Fees

Program license fees are comprised of the following:

As of December 31,

As of June 30,

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	2011	(In thousands)	2012
Program license fees non-affiliates	\$	549,915	\$ 511,839
Program license fees Hallmark Cards affiliates		16,500	19,759
Program license fees, at cost		566,415	531,598
Accumulated amortization		(315,451)	(297,215)
Program license fees, net	\$	250,964	\$ 234,383

At December 31, 2011, and June 30, 2012, \$11.5 million and \$31.4 million, respectively, of program license fees were included in prepaid program license fees on the accompanying condensed consolidated balance sheets. The various license periods associated with such amounts had not commenced as of the respective balance sheet dates.

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License fees payable are comprised of the following:

	As of December 31, 2011	As of June 30, 2012
	(In thousands)	
License fees payable non-affiliates	\$ 133,212	\$ 108,504
License fees payable Hallmark Cards affiliates	11,293	13,584
Total license fees payable	144,505	122,088
Less current maturities	(135,768)	(107,261)
Long-term license fees payable	\$ 8,737	\$ 14,827

In the regular course of evaluating the remaining usefulness of its various program licenses, the Company may determine that certain licenses may be of little future program value. In such instances, the Company shortens the estimated remaining lives to zero, thereby accelerating amortization of the remaining net book value. During the three and six months ended June 30, 2011, such changes in estimates resulted in additional amortization of program license fees of \$600,000. During the three and six months ended June 30, 2012, such changes in estimates resulted in additional amortization of program license fees of \$1.3 million. Additionally, the Company evaluated the remaining usefulness of its film asset and recognized \$1.3 million of impairment expense during both the three and six months ended June 30, 2012. This impairment is included as a component of non-affiliate programming costs in the accompanying unaudited condensed consolidated statement of operations.

Under certain license agreements with RHI Entertainment Distribution, LLC (RHIED) the Company is obligated to pay \$5.3 million through December 1, 2013. In connection with its reorganization in bankruptcy, RHIED assigned its right to receive these license payments to Hallmark Cards. During the six months ended June 30, 2011, the Company reclassified \$2.5 million from license fees payable (to non-affiliates) to payables to Hallmark Cards affiliates. During the same period the Company remitted payment of \$1.3 million to Hallmark Cards. At December 31, 2011, the payable to Hallmark Cards affiliates included \$1.3 million related to this assignment. During the six months ended June 30, 2012, the Company reclassified \$748,000 from license fees payable (to non-affiliates) to payables to Hallmark Cards affiliates. During the same period the Company remitted payment of \$1.3 million to Hallmark Cards. At June 30, 2012, the payable to Hallmark Cards affiliates includes \$670,000 related to this assignment. Obligations relating to license periods that had not commenced as of December 31, 2011, and June 30, 2012, were \$2.7 million and \$2.1 million, respectively; accordingly, such amounts are not reflected in the accompanying unaudited condensed consolidated balance sheet. See Commitments and Contingencies below.

4. Revolving Credit Facilities, Term Loan, and the Notes

Credit Facilities and Term Loan

On July 14, 2011, in connection with the 2011 Refinancing, the Company entered into a new \$240.0 million credit agreement (the Credit Agreement) with the lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent. The Credit Agreement provides for a seven year \$210.0 million senior secured term loan facility (the Term Loan) and a five year \$30.0 million senior secured super-priority revolving credit facility (the Credit Facility). The Term Loan was issued at a discount of 1.0% or \$2.1 million.

At both December 31, 2011, and June 30, 2012, the Company had no outstanding borrowings under the Credit Facility. There were no letters of credit outstanding at December 31, 2011; one letter of credit was outstanding in the amount of \$202,000 at June 30, 2012. Interest expense on

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borrowings under the Credit Facility for the three and six months ended June 30, 2012, was \$0. Commitment fees on the Credit Facility are payable on the unused revolving credit commitment at the rate of 0.50% per annum, payable quarterly. Commitment fee expense for the three months ended June 30, 2011 and 2012, was \$29,000 and \$38,000, respectively. Commitment fee expense for the six months ended June 30, 2011 and 2012, was \$57,000 and \$76,000, respectively. Commitment fee expense is included as a component of interest expense on the accompanying unaudited condensed consolidated statements of operations.

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The Term Loan was drawn on July 14, 2011, at LIBOR at the Company's election. All LIBOR term loans will bear interest at the LIBOR Rate (subject to a minimum rate of 1.25%) plus 4.50%. The interest rate at both December 31, 2011, and June 30, 2012, was 5.75%.

The provisions of the Term Loan require the Company to make principal payments of \$525,000 at each quarter's end, commencing September 30, 2011, until maturity on July 14, 2018. The Company is required to make additional principal payments in amounts equal to (1) 50% of excess cash flow (as defined in the Credit Agreement) of the Company for the remainder of 2011, and each year thereafter, which percentage will be reduced to 25% if the Consolidated Leverage Ratio (as defined in the Credit Agreement) is equal to or less than 4.25 to 1 but greater than 3.25 to 1, and 0% if the Consolidated Leverage ratio is equal to or less than 3.25 to 1, respectively; (2) 100% of net cash proceeds of dispositions or casualty events if the Company has not invested such proceeds within one year after the occurrence of the disposition or casualty event; and (3) 100% of net cash proceeds from issuance of debt or preferred stock not otherwise permitted by the Credit Agreement.

The covenants in the Credit Agreement limit the ability of the Company and certain of its subsidiaries to (1) incur indebtedness; (2) create or permit liens on assets; (3) make certain dividends, stock repurchases and redemptions and other restricted payments; (4) make certain investments; (5) prepay indebtedness; (6) enter into certain transactions with the Company's affiliates; (7) dispose of substantially all of the assets of the Company; (8) merge or consolidate; (9) enter into new unrelated lines of businesses; and (10) enter into sale and leaseback transactions. The Credit Agreement also requires compliance with a maximum total leverage ratio test and a maximum total secured leverage ratio test, but permits, with certain limitations, certain equity contributions to be made to the Company to enhance its ability to comply with such ratio tests.

The credit facility contains a number of affirmative and negative covenants. The Company was in compliance with these covenants as of June 30, 2012.

The Company made principal payments of \$525,000 and \$18.6 million under the Term Loan during the three and six months ended June 30, 2012, respectively. Interest expense under the Term Loan was \$2.9 million and \$6.2 million for three and six months ended June 30, 2012, respectively. After giving effect to the amortization of associated debt issuance costs and original issue discount, the effective interest rate of the Term Loan was approximately 6.3% during the six months ended June 30, 2012.

The Notes

On July 14, 2011, also as part of the 2011 Refinancing, the Company issued \$300.0 million in aggregate principal amount of 10.5% Senior Notes, at par, due July 15, 2019 (the "Notes") in a private placement conducted pursuant to Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"). Subsequently, Crown Media Holdings and the Guarantors filed a registration statement with the Securities and Exchange Commission and exchanged the Notes for a new issuance of substantially identical notes registered under the Securities Act. The Notes are guaranteed on a senior basis by each of Crown Media Holdings' subsidiaries (the "Guarantors").

Commencing January 15, 2012, interest is payable each January 15th and July 15th. The Company is not required to make mandatory sinking fund payments with respect to the Notes.

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The covenants in the related indenture limit the ability of the Company to, among other things (1) incur additional debt; (2) pay dividends or make other restricted payments; (3) purchase, redeem or retire capital stock or subordinated debt; (4) make asset sales, including by way of sale leaseback transactions; (5) provide subsidiary guarantees; (6) enter into transactions with affiliates; (7) incur liens; (8) make investments; and (9) merge or consolidate with any other person.

During any period in which the Notes have an investment grade rating from both Moody's and S&P (at least Baa3 by Moody's and BBB- by S&P), and no default has occurred and is continuing under the Indenture, Crown Media Holdings and its restricted subsidiaries will not be required to comply with the covenants in the Indenture that limit their ability to (1) incur additional debt; (2) pay dividends or make other restricted payments; (3) purchase,

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redeem or retire capital stock or subordinated debt; (4) make asset sales; (5) provide subsidiary guarantees; and (6) enter into transactions with affiliates. The Company was in compliance with these covenants as of June 30, 2012.

Interest expense under the Notes was \$8.1 million and \$16.1 million for the three and six months ended June 30, 2012, respectively. After giving effect to the amortization of associated debt issuance costs, the effective interest rate of the Notes was approximately 11% during the six months ended June 30, 2012.

Maturities

Required payments of principal and interest (excluding future excess cash flow amounts and including future interest) for each of the five years subsequent to June 30, 2012, and the period thereafter, are as follows:

	Total	Year 1	Year 2	Payments Due by Period			Year 4	Year 5	Thereafter
				Year 3					
	(In thousands)								
The Notes, due July 15, 2019	\$ 536,250	\$ 31,500	\$ 31,500	\$ 31,500	\$ 31,500	\$ 31,500	\$ 31,500	\$ 31,500	\$ 378,750
Term Loan, due July 14, 2018	255,347	13,184	13,032	12,910	12,816	12,665	12,665	190,740	
	\$ 791,597	\$ 44,684	\$ 44,532	\$ 44,410	\$ 44,316	\$ 44,165	\$ 44,165	\$ 569,490	

Early Extinguishment of Debt and Redemption of Preferred Stock

The proceeds of the Term Loan and the Notes were used by the Company to (i) repay borrowings under the Term A Loan and Term B Loan, both of which were payable to HCC and (ii) redeem all of the Company's outstanding Series A Preferred Stock, all of which was held by HCC.

At the time of the 2011 Refinancing, the carrying amounts of the Term A Loan, the Term B Loan and Preferred Stock exceeded the respective reacquisition and redemption prices by approximately \$87.3 million and \$15.7 million, respectively. In consideration of these carrying amounts having been derived from the provisions of the Recapitalization in which HCC was a significant participant, the benefits arising from the extinguishments and redemption, \$103.0 million in the aggregate, have been deemed capital contributions by HCC. Accordingly, such benefits have been credited to additional paid-in capital, net of tax, in the accompanying condensed consolidated balance sheet. The tax impact of these deemed capital contributions was \$0, which is reflective of a reduction in the gross deferred tax assets related to the Term A and Term B loans of \$32.5 million and offsetting reduction in the deferred tax valuation allowance of \$32.5 million.

Guarantees

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Crown Media Holdings has no independent assets or operations, the guarantees by the subsidiary guarantors are full and unconditional, joint and several, and there are no subsidiaries of Crown Media Holdings that are not subsidiary guarantors. With certain exceptions described above, the Notes and the Credit Facilities impose restrictions on the payment of dividends by Crown Media Holdings and the subsidiary guarantors.

5. Related Party Obligations

2011 Refinancing Transaction

The proceeds of the Notes and the Term Loan were used to repay all borrowings under the Term A and Term B Loans and to redeem all the Series A Preferred Stock, consisting of 185,000 shares held by HCC. On July 14, 2011, the Company paid principal and interest of \$191.4 million and \$115.5 million under its Term A and Term B Loans,

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respectively, and redeemed its Preferred Stock of \$185.0 million and paid dividends on its Preferred Stock of \$993,000.

Related Party Long-Term Obligations

For financial reporting purposes, the Recapitalization was accounted for as a troubled debt restructuring in accordance with the guidance of ASC *Topic 470-60 Debt Troubled Debt Restructurings*. Pursuant to the guidance in the ASC, we (1) recorded the issuance of Preferred Stock and Common Stock at their respective estimated fair values as of June 29, 2010 and (2) recorded New Debt in an amount equal to the residual of (i) the carrying value of HCC Debt less (ii) the estimated fair values of such Preferred Stock and Common Stock. New Debt was apportioned between the Term A and Term B Loans on the basis of their relative fair values. The amounts by which the apportioned Term Loans exceeded the respective stated amounts of principal were amortized over the terms of the loans as reductions of the interest expense that otherwise would have arisen from the stated cash interest rates. The resulting effective interest rates were approximately 0.789% and 1.002%, for the Term A Loan and Term B Loan, respectively, through March 9, 2011. The effective interest rate for the Term A Loan decreased to approximately 0.355% on March 10, 2011, subsequent to the Company's \$9.3 million principal payment.

The Company paid principal of \$7.2 million and interest of \$603,000 during the three months ended June 30, 2011, on the Term A and Term B Loans. The Company paid principal of \$23.6 million and interest of \$1.4 million during the six months ended June 30, 2011, on the Term A and Term B Loans.

Hallmark Guarantee; Interest and Fee Reductions

Hallmark Cards unconditionally guaranteed the Company's obligations to JPMorgan Chase Bank under the credit facility that expired on July 14, 2011. This credit support provided by Hallmark Cards resulted in reductions in the interest rate and commitment fees under the credit facility through July 14, 2011; however, the Company agreed to pay and has paid an amount equal to the reductions in the interest rate and commitment fees to Hallmark Cards. The Company paid Hallmark Cards a reduction amount of the interest rate and commitment fees equal to 0.75% and 0.125%, respectively. Commitment fee expense for the three and six months ended June 30, 2011, was \$10,000 and \$19,000, respectively.

6. Related Party Transactions

Tax Sharing Agreement

On March 11, 2003, the Company became a member of Hallmark Cards' consolidated federal tax group and entered into a federal tax sharing agreement with Hallmark Cards (the "federal tax sharing agreement"). Hallmark Cards includes the Company in its consolidated federal income tax return. Accordingly, Hallmark Cards has benefited from subsequent tax losses and may benefit from future federal tax losses, which may be generated by the Company. Based on the original federal tax sharing agreement, Hallmark Cards agreed to pay the Company all of the benefits realized by Hallmark Cards as a result of including the Company in its consolidated income tax return. Also, taxable income recognized by the Company that is included in the Hallmark Cards consolidated tax return will result in a payment by the Company to Hallmark Cards.

On a quarterly basis through December 31, 2008, Hallmark Cards paid the Company cash for 75% of the estimated benefit from losses with the balance applied as an offset against other amounts owed by the Company to any member of the Hallmark Cards consolidated group under any loan, line of credit or other payable, subject to limitations under any loan indentures or contracts restricting such offsets. As part of the Recapitalization, the federal tax sharing agreement was amended to provide that 100% of any such benefit will be deferred for application against future tax liabilities of the Company.

The Company owed Hallmark Cards \$15.3 million under the federal tax sharing agreement for 2011 with \$10.5 million paid in cash and the balance offset against the overpayment of the 2010 tax sharing payment; any amounts remaining will be paid in cash to Hallmark Cards during 2012 (approximately \$3.3 million will be paid in October

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2012). In respect of the first quarter of 2012 amount due of \$5.4 million, the Company paid \$4.4 million in May 2012 and the remaining \$1.0 million was offset against the 2010 overpayment. The Company owed Hallmark Cards \$6.2 million under the federal tax sharing agreement for 2012 as of June 30, 2012. The Company paid \$6.2 million in respect of the second quarter in July 2012.

Any payments received from Hallmark Cards or credited against amounts owed by the Company to any member of the Hallmark Cards consolidated group under the tax sharing agreements have been recorded as additions to paid-in capital in the accompanying consolidated statements of stockholders' equity. Any amounts owed or payments made to Hallmark Cards or to any member of the Hallmark Cards consolidated group under the tax sharing agreement in excess of current tax expense have been recorded as reductions to paid-in capital.

Since May 9, 2000, the Company has been included in certain combined state income tax returns of Hallmark Cards or Hallmark Entertainment Holdings. Consequently, Hallmark Entertainment Holdings and the Company entered into a state tax sharing agreement. Under the state tax sharing agreement, Hallmark Cards (as successor to Hallmark Entertainment Holdings) and the Company file consolidated, combined or unitary state tax returns. The Company makes tax-sharing payments to (or receives payments from) Hallmark Cards equal to the taxes (or tax refunds) that the Company would pay (or receive) if it filed on a stand-alone basis. Such payments are computed based on the Company's taxable income (loss) and other tax items beginning the day following the May 9, 2000, reorganization. At June 30, 2012, the estimated amounts due to Hallmark Cards related to the state tax sharing agreement were \$787,000, \$248,000 with respect to 2012 and \$539,000 with respect to 2011. This amount will be payable two days prior to the due date of the state tax returns. In 2011, the Company paid \$751,000 to Hallmark Cards related to 2010 state tax sharing payments and \$20,000 related to 2011 state estimated payments.

Services Agreement with Hallmark Cards

Hallmark Cards provides Crown Media Holdings with tax, risk management, health safety, environmental, insurance, legal, treasury, human resources, cash management and real estate consulting services. In exchange, the Company is obligated to pay Hallmark Cards a fee, plus out-of-pocket expenses and third party fees, in arrears on the last business day of each quarter. Fees for Hallmark Cards' services were \$448,000 for 2011 and are \$457,000 for 2012.

At December 31, 2011, and June 30, 2012, the Company's payables to Hallmark Cards affiliates on the accompanying condensed consolidated balance sheets were \$4.1 million and \$11.0 million, respectively. The December 31, 2011, balance was comprised of \$2.8 million of taxes due under the federal and state tax sharing agreements and \$1.3 million of assigned license payments. The June 30, 2012, balance was comprised of \$10.3 million of taxes due under the federal and state tax sharing agreements and \$670,000 of assigned license payments.

Hallmark Hall of Fame Programming License Agreement

In 2008, Crown Media United States entered into an agreement with Hallmark Hall of Fame Productions, LLC for the exclusive television license of 58 Hallmark Hall of Fame movies, consisting of 16 contemporary Hallmark Hall of Fame titles (*i.e.*, produced from 2003 to 2008) and 42 older titles, for exhibition on Hallmark Channel and Hallmark Movie Channel. These titles are licensed for ten year windows, which commenced at various times between 2007 and 2010, depending on availability. The total license fee for these movies is \$17.2 million and is payable in equal monthly installments over the various 10-year exhibition windows.

In 2011 Crown Media United States entered into an additional agreement with Hallmark Hall of Fame Productions, LLC for the exclusive television license of 16 Hallmark Hall of Fame movies produced from 2009 through 2014, for exhibition on Hallmark Channel and Hallmark Movie Channel. These titles are licensed for ten year windows, with windows commencing at various times between 2011 and 2014, depending on availability. The total license fee for these movies is \$10.0 million and is payable in equal monthly installments over the various 10-year exhibition windows.

On July 6, 2011, the Company and Hallmark Cards entered into an agreement whereby Hallmark Cards will provide the Company one-week, limited play licenses for each of six new Hallmark Hall of Fame two-hour

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movies produced by Hallmark Cards over the two-year contract term. In exchange for approximately two-thirds of the advertising units otherwise available during each airing of the movies, Hallmark Cards will pay the Company \$3.4 million of cash ratably as the individual licenses open. The Company has estimated the fair value of the program licenses to be approximately \$1.0 million. The Company will recognize total advertising revenue of approximately \$4.4 million as it fulfills its advertising obligation to Hallmark Cards. As of the date of this Report, three of such movies had aired on Hallmark Channel.

Trademark Agreement with Hallmark Cards

In connection with the 2011 Refinancing, Hallmark Licensing, LLC, an affiliate of Hallmark Cards, extended two existing trademark licenses (the Extended Licenses) with Crown Media United States for an additional period terminating the earlier of (i) July 14, 2019 and (ii) the later of (x) the expiration or termination of the Credit Agreement and (y) the redemption of all of the Notes, subject to any earlier termination of such license agreements pursuant to the respective terms of such license agreements.

The Company is not required to pay any fees under the trademark license agreements. The Company has accounted for the agreements pursuant to the contractual terms of the arrangement, which is royalty free. Accordingly, no amounts have been reflected in the unaudited condensed consolidated balance sheets or unaudited condensed consolidated statements of operations and of the Company.

7. Release of Valuation Allowance

The Company had established a deferred tax asset of \$610.2 million as of December 31, 2010, and had recorded a full valuation allowance against it.

During 2011, after evaluating positive and negative evidence, including recent earnings history, the Company determined that it was more likely than not that it would utilize a portion of its tax loss carry forwards, as if separate returns were filed.

In consideration of the expected realization of deferred tax assets in years beyond 2011, in particular, (i) the expected future reversal of existing taxable temporary differences and (ii) expected future taxable income exclusive of reversing temporary differences and carry forwards, the Company released \$236.0 million of its valuation allowance (\$44.2 million during the first quarter of 2011 and \$191.8 million during the third quarter of 2011). Correspondingly, an unreserved deferred tax asset of \$236.0 million is reflected on the accompanying condensed consolidated balance sheet as of December 31, 2011. The related \$236.0 million effect on the accompanying condensed consolidated statement of operations for the year ended December 31, 2011, was a non-cash income tax benefit.

The Company will continue to evaluate the available positive and negative evidence in subsequent periods and adjust its remaining valuation allowance to an amount it determines to be more likely than not to be realized.

At June 30, 2012, an unreserved deferred tax asset of \$221.5 million is reflected on the accompanying condensed consolidated balance sheet. The Company recorded income tax provisions of \$8.3 million and \$15.6 million in the accompanying condensed consolidated statements of operations for the three and six months ended June 30, 2012, respectively, which are primarily non-cash income tax expenses.

8. Share-Based Compensation and Long Term Incentive Plan

Share-Based Compensation

The Company recorded \$6,000 and \$84,000 of compensation expense associated with the RSUs during the three months ended June 30, 2011 and 2012, respectively, which have been included in selling, general and administrative expense on the accompanying condensed consolidated statements of operations. The Company recorded \$46,000 and \$155,000 of compensation expense associated with the RSUs during the six months ended June 30, 2011 and

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2012, respectively, which have been included in selling, general and administrative expense on the accompanying condensed consolidated statements of operations.

As of December 31, 2011, and June 30, 2012, there were no unrecognized compensation costs, related to non-vested stock options granted to the Company's directors. The RSU liability is adjusted monthly to reflect the closing price of the Company's common stock. At December 31, 2011, and June 30, 2012, the closing prices per share were \$1.21 and \$1.75, respectively. As of December 31, 2011, and June 30, 2012, there were unrecognized compensation costs related to non-vested RSUs granted to the Company's directors, in the amounts of \$236,000 and \$162,000, respectively, using the aforementioned stock prices. Actual compensation costs recognized in future periods may vary based upon fluctuations in stock price and forfeitures.

No cash settlements related to the RSUs were issued during the three and six months ended June 30, 2011 and 2012, respectively.

Long Term Incentive Plan

In the second quarter of 2009, the Company granted Long Term Incentive Compensation Agreements (LTI Agreements) to each vice president, senior vice president, executive vice president and president of the Company. The target award under each LTI Agreement was a percentage of the employee's base salary and ranged from \$26,000 to \$469,000. Of each grant, 50% was an Employment Award (as defined under the LTI Agreements) and 50% was a Performance Award (as defined under the LTI Agreements). The Employment Award vested on August 31, 2011, and was settled in cash on September 2, 2011, in the amount of \$1.1 million. A portion of the Performance Award vested on December 31, 2010, and was subsequently settled in the first quarter of 2011 in the amount of \$157,000; the remaining 50% did not vest on December 31, 2011, in accordance with the Company performance criteria concerning adjusted EBITDA and cash flow.

In the first quarter of 2010, the Company granted LTI Agreements ranging from \$25,000 to \$536,000. The 50% Employment Award will vest on August 31, 2012, and be settled in cash within 30 days thereafter, subject to earlier pro rata settlement as provided in the LTI Agreement. The 50% Performance Award will vest on December 31, 2012, if the performance criteria are achieved, and be settled in cash the later of 30 days thereafter or 15 days after the Company issues its audited financials for 2012, but by no later than March 15, 2013.

In the second quarter of 2011, the Company granted LTI Agreements ranging from \$23,000 to \$550,000. The 50% Employment Award will vest on August 31, 2013, and be settled in cash within 30 days thereafter, subject to earlier pro rata settlement as provided in the LTI Agreement. The 50% Performance Award will vest on December 31, 2013, if the performance criteria are achieved, and be settled in cash the later of 30 days thereafter or 15 days after the Company issues its audited financials for 2013, but by no later than March 15, 2014.

In the first quarter of 2012, the Company granted LTI Agreements ranging from \$22,000 to \$652,000. The 50% Employment Award will vest on August 31, 2014, and be settled in cash within 30 days thereafter, subject to earlier pro rata settlement as provided in the LTI Agreement. The 50% Performance Award will vest on December 31, 2014, if the performance criteria are achieved, and be settled in cash the later of 30 days thereafter or 15 days after the Company issues its audited financials for 2014, but by no later than March 15, 2015.

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Vesting of the 2010, 2011 and 2012 Performance Awards will be determined in accordance with the Company performance criteria concerning adjusted EBITDA and cash flow and subject to earlier pro rata settlement as provided in the LTI Agreement.

In recognition of these agreements, the accompanying condensed consolidated statements of operations include \$503,000 and \$739,000 among selling, general and administrative expense for the three months ended June 30, 2011 and 2012, respectively, and the accompanying condensed consolidated statements of operations include \$867,000 and \$1.3 million among selling, general and administrative expense for the six months ended June 30, 2011 and 2012, respectively. Additionally, the \$2.2 million and \$3.5 million liability for these agreements was included in

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accounts payable and accrued liabilities in the accompanying consolidated balance sheets at December 31, 2011 and June 30, 2012, respectively.

9. Fair Value

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2011, and June 30, 2012.

	December 31, 2011		June 30, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In thousands)			
Term Loan and interest payable (Level 3)	\$ 209,578	\$ 201,346	\$ 188,617	\$ 186,027
The Notes and interest payable (Level 2)	314,525	330,278	314,438	338,482

ASC Topic 820 *Fair Value Measurements and Disclosures* defines fair value of a liability as the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company estimated the fair value of the Notes using the trading prices obtained from a third-party source on December 31, 2011, and June 30, 2012, a Level 2 input, due to the limited amount of trading activity. The Company estimated the fair value of its Term Loan using a yield-to-maturity rate obtained from a pricing service, a Level 3 input.

At December 31, 2011, and June 30, 2012, the fair values of the Level 3 financial instruments were \$201.3 million and \$186.0 million, respectively. No transfers between levels occurred during 2011 and 2012.

Accounts payable and receivable are carried at reasonable estimates of their fair values because of the short-term nature of these instruments. Interest rates on borrowings under the bank credit facility are for relatively short periods and variable. Therefore, the fair value of this debt is not significantly affected by fluctuations in interest rates. The credit spread on the debt is fixed, but the market rate will fluctuate.

10. Commitments and Contingencies

In the normal course of business, the Company has entered into agreements that commit it to make cash payments in future periods with respect to non-cancelable leases and programming contracts.

Lawsuit

From time to time, the Company and/or various officers and directors may be named as defendants in legal actions involving various claims incident to the conduct of its business. Whenever the Company concludes that an adverse outcome in any such action is probable and a loss amount can reasonably be estimated, the Company records such loss amount. Related legal costs, net of anticipated insurance reimbursements, are expensed as incurred.

A lawsuit was brought in July 2009 in the Delaware Court of Chancery against the Company's Board of Directors, Hallmark Cards, Incorporated and its affiliates, as well as the Company as a nominal defendant, by S. Muoio & Co. LLC (Muoio), a minority stockholder of the Company, regarding a recapitalization proposal which the Company received from Hallmark Cards in May 2009. The lawsuit alleged, among other things, that the recapitalization was for an unfair price and undervalued the Company. The complaint requested the court enjoin the defendants from consummating the recapitalization transactions and award plaintiff fees and expenses incurred in bringing the lawsuit. Following the execution by the Company of the Recapitalization agreements, on March 11, 2010, the plaintiff filed an amended complaint raising similar allegations and seeking rescission of the Recapitalization. The Recapitalization was consummated on June 29, 2010.

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A trial took place in September 2010. On March 9, 2011, the Delaware Court of Chancery concluded that the process and the price of the Recapitalization were entirely fair and entered a final judgment order in favor of the defendants on all claims and dismissed the lawsuit with prejudice. This ruling was affirmed by the Delaware Supreme Court on December 20, 2011.

The accompanying unaudited condensed consolidated balance sheets include approximately \$1.8 million and \$1.7 million in accounts receivable at December 31, 2011, and June 30, 2012, respectively, for litigation costs for which the Company expects to be reimbursed by its insurance company. Similarly, the accompanying unaudited condensed consolidated balance sheets include approximately \$202,000 and \$0 in accounts payable and accrued liabilities at December 31, 2011, and June 30, 2012, respectively, related to litigation costs.

Guarantee

As discussed further under Program License Fees, RHIED assigned to Hallmark Cards its right to receive \$5.3 million in program license fees from the Company. The assignment relates to a 2002 guarantee issued by HEH to an unaffiliated movie production company on behalf of RHIED. At that time, HEH was a wholly-owned subsidiary of Hallmark Cards and an intermediate parent of the Company. Also at that time, RHIED was a wholly-owned subsidiary of HEH; it ceased to be affiliated with Hallmark Cards in January 2006. As part of the Recapitalization, HEH was merged with the Company. In August 2010 the unaffiliated production company made demand of the Company for payment of amounts owed by RHIED. Hallmark Cards subsequently assumed defense of the claim and fully indemnified the Company. On December 10, 2010, RHIED filed for reorganization in bankruptcy. Pursuant to a settlement and release agreement among the unaffiliated production company, RHIED, Hallmark Cards and the Company, the Company's obligation under the guarantee was extinguished. The settlement and release agreement was approved by the bankruptcy court on February 17, 2011 and became final and non-appealable on March 3, 2011.

Indemnifications of Third Parties for Residuals and Participations Liabilities

In December 2006, the Company sold its film library consisting of domestic rights and certain international ancillary rights to approximately 620 television movies, mini-series and series (the Crown Library) to RHI Entertainment LLC (RHI). As a condition of the sale, the Company agreed to pay up to \$22.5 million for residuals and profit participations related to RHI's domestic exploitation of the Crown Library for a ten-year period ending December 14, 2016. The Company estimated the fair value of this obligation to be approximately \$10.6 million at December 15, 2006, assuming the maximum payout.

In December 2011 the Company and RHI executed an agreement pursuant to which the Company acquired program licenses and was relieved of its remaining obligation under the indemnification agreement, all in exchange for concurrent and future fixed cash payments of \$8.1 million. The program license assets were recorded at their estimated fair values of approximately \$3.8 million with corresponding recognition of license fees payable. The remainder of the payment obligation was recorded at its estimated fair value of approximately \$4.1 million, which is being accreted through December 2013. The carrying amount of this liability as of December 31, 2011, and June 30, 2012, was \$3.5 million and \$3.6 million, respectively, and is included among accrued liabilities in the accompanying unaudited condensed consolidated balance sheet.

Also, included in accounts payable and accrued liabilities as of December 31, 2011, and June 30, 2012, is \$406,000 and \$431,000, respectively, for the estimated cost of residuals and participations that the buyer of our international business (which included the international rights to our film library) would otherwise be obligated to pay to third parties in connection with international film library sales between the April 2005 sale

and April 2015. The Company's actual cost of this obligation will depend on the actual internal usage or sales of these films by the buyer.

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Lease

The lease agreement dated September 8, 2008, for the Company's office located in New York was amended effective May 25, 2012. Pursuant to the amendment, Company will lease an additional space of 7,341 rentable square feet for \$1.7 million cumulative rent expense.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and related notes included in Part I, Item 1 in this Quarterly Report on Form 10-Q. The following analysis contains forward-looking statements about our future revenue, operating results and expectations. See "Forward-looking information" and "Risk factors" below for a discussion of the risks, assumptions and uncertainties affecting these statements.

Description of Business and Overview

Current Business

We own and operate pay television Networks, each of which is dedicated to high-quality entertainment programming for families. Hallmark Channel features popular television series such as *Golden Girls* and *Frasier* as well as original movies with compelling stories and internationally recognized stars. It also offers a lifestyle programming block currently featuring *The Martha Stewart Show* and *Emeril's Table* featuring Chef Emeril Lagasse. In the fourth quarter of 2012, the Martha Stewart programming in this lifestyle block will be replaced by two new original series *Home and Family* and *Marie*, with Marie Osmond. Hallmark Movie Channel is a cable network dedicated to offering movies appropriate for the entire family, consisting primarily of original movies, classic theatrical films, and presentations from the award-winning Hallmark Hall of Fame collection as well as other long form television programming. Consistent with the Hallmark brand, both Networks are a preeminent source of holiday programming, with Hallmark Channel often ranking first among cable networks for movies during the Christmas holiday season.

Reaching approximately 87.4 million subscribers, Hallmark Channel is one of the most widely distributed independent networks in the United States. Hallmark Movie Channel is one of the fastest-growing new cable networks, reaching approximately 47.2 million subscribers.

We believe that we have established these Networks as destinations for viewers seeking outstanding family entertainment and as attractive outlets for advertisers seeking to target these viewers.

Our Networks offer a range of high-quality entertainment programming for adults and families including popular television series, movies, miniseries, theatricals, romances, literary classics, and contemporary stories. Sources for programming on our Networks include programming

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(both movies and series) licensed from Buena Vista Television, CBS Television Distribution, Hallmark Hall of Fame, Martha Stewart Living Omnimedia, MGM, Paramount Pictures, Sonar Entertainment, Inc., Twentieth Television, Warner Bros. and others.

Programming acquired from third parties is an important component of our Networks as we continually develop and refine our programming strategy. This programming includes original movies and lifestyle programming produced by a variety of experienced television production companies specifically for us and theatrical movies and off network television series licensed to us by major studios and distributors. Our agreements for original movies and lifestyle programming typically provide for exclusive rights in the United States in all media for periods ranging from 8 years to perpetuity. Our license agreements for theatrical films and off-network programming usually give us the more limited right to exhibit the programming on our Networks, over a period of five or more years. From time to time, for promotional purposes, we also exhibit excerpts of certain programming on our website.

Hallmark Channel is currently distributed to approximately 84% of all United States pay television subscribers. We currently distribute (a) Hallmark Channel through approximately 5,472 cable, satellite and other pay television distribution systems and (b) Hallmark Movie Channel through approximately 3,154 such systems.

Five of our distributors each accounted for more than 10% of our consolidated subscriber revenue for both the

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three months ended June 30, 2011 and 2012, and together accounted for a total of 83% and 84% of consolidated subscriber revenue during the three months ended June 30, 2011 and 2012, respectively. Three of our distributors each accounted for approximately 15% or more of our consolidated subscribers for both the three months ended June 30, 2011 and 2012, respectively, and together accounted for 60% and 61% of our subscribers during the three months ended June 30, 2011 and 2012, respectively. The loss of one of these distributors could have a significant impact on the Company's operations.

Four of our distributors each accounted for more than 10% of our consolidated subscriber revenue for both the six months ended June 30, 2011 and 2012, and together accounted for a total of 74% and 75% of consolidated subscriber revenue during the six months ended June 30, 2011 and 2012, respectively. Three of our distributors each accounted for approximately 15% or more of our consolidated subscribers for both the six months ended June 30, 2011 and 2012, respectively, and together accounted for 60% and 61% of our subscribers during the six months ended June 30, 2011 and 2012, respectively. The loss of one of these distributors could have a significant impact on the Company's operations.

Three of our programming content providers each accounted for more than 10% of our total license fee programming for both the six months ended June 30, 2011 and 2012, and together accounted for a total of 57% and 55% of the consolidated programming liability, respectively.

We view a subscriber as a household that receives, on a full- or part-time basis, a network as part of a program package or a program tier of a distributor. We determine our Hallmark Channel and Hallmark Movie Channel subscribers from subscriber numbers reported by Nielsen Media Research. Subscribers include both viewers who pay a monthly fee for the tier programming and so-called promotional subscribers who are given free access to the tier by the distributor for a limited time.

We license the trademark Hallmark for use on our Networks pursuant to certain trademark license agreements with a subsidiary of Hallmark Cards. We believe that the use of this trademark is extremely important for our Networks due to the substantial name recognition and favorable characteristics associated with the name in the United States.

Among the 96 ad-supported cable networks in the United States market in the second quarter of 2012, Hallmark Channel ranked 19th in total day viewership with an average 0.4 household rating and 32nd for prime time with an average 0.5 household rating, according to Nielsen Media Research. Among the 96 ad-supported cable networks in the United States market in the second quarter of 2012, Hallmark Movie Channel ranked 31st in total day viewership with an average 0.3 household rating and 42nd for prime time with an average 0.3 household rating, according to Nielsen Media Research. Among the 96 ad-supported cable networks in the United States market in the second quarter of 2012, Hallmark Channel ranked 19th in total day viewership with an average 0.2 Women 25-54 rating and 23rd for prime time with an average 0.3 Women 25-54 rating, according to Nielsen Media Research. Among the 96 ad-supported cable networks in the United States market in the second quarter of 2012, Hallmark Movie Channel ranked 36th in total day viewership with an average 0.1 Women 25-54 rating and 46th for prime time with an average 0.1 Women 25-54 rating, according to Nielsen Media Research.

Among the 86 ad-supported cable networks in the United States market in the second quarter of 2011, Hallmark Channel ranked 23rd in total day viewership with an average 0.4 household rating and 32nd for prime time with an average 0.5 household rating, according to Nielsen Media Research. Among the 86 ad-supported cable networks in the United States market in the second quarter of 2011, Hallmark Movie Channel ranked 41st in total day viewership with an average 0.2 household rating and 44th for prime time with an average 0.3 household rating, according to Nielsen Media Research. Among the 86 ad-supported cable networks in the United States market in the second quarter of 2011, Hallmark Channel ranked 21st in total day viewership with an average 0.2 Women 25-54 rating and 23rd for prime time with an average 0.3 Women 25-54 rating, according to Nielsen Media Research. Among the 86 ad-supported cable networks in the United States market in the second quarter of 2011, Hallmark Movie Channel ranked 36th in total day viewership with an average 0.1 Women 25-54 rating and 48th for prime time with an

average 0.1 Women 25-54 rating, according to Nielsen Media Research.

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Current Challenges

The Company faces numerous operating challenges. Among such challenges are increasing viewership ratings, maintaining and increasing advertising revenue, maintaining and expanding the distribution of the Networks, broadening viewership demographics to meet our target audience, and controlling costs and expenses.

Ratings

Ratings success plays a significant role in our ability to achieve our distribution and advertising goals. We believe our ratings are affected by our ability to (i) acquire and produce series and original movies that appeal to our target demographic and (ii) develop a programming schedule that attracts a high number of viewers. Original productions are our most high profile programs and generate Hallmark Channel's highest ratings. In the past, the Company has typically incurred additional marketing and promotional expenses surrounding original productions and certain acquired movies to drive higher ratings. Certain acquired series delivered historically strong ratings, but recently they have been part of the decline experienced in viewer ratings. We plan to continue or increase the number of our original productions and develop a programming schedule that attracts a greater number of viewers in our target demographic, all while controlling the costs and expenses relating to these actions.

Advertising Revenue

In the second quarter of 2012, our sales of inventory in the scatter market were at rates 36% greater than the rates we realized for 2011/2012 upfront sales and were generally lower than those we realized in the 2011 scatter market by approximately 14%. Our average direct response rates were up 4% compared to inventory sold in the same period of 2011, but the volume of inventory sold and rates realized varied by daypart.

In the 2011/2012 upfront process relating to the sale of advertising for the last quarter of 2011 and the first three quarters of 2012, we entered into agreements with major advertising firms covering approximately 43% of our advertising inventory. In the 2010/2011 upfront process relating to the sale of advertising for the last quarter of 2010 and the first three quarters of 2011, we entered into agreements with major advertising firms covering approximately 40% of our advertising inventory. The 2011/2012 inventory was sold at CPMs 11% higher than the inventory sold in the 2010/2011 upfront, including increases in rates related to our lifestyle programming block. We sold additional general rate inventory for the 2010/2011 broadcast season to advertisers that purchase upfront inventory on a calendar year basis, rather than an advertising year basis, and sold the balance in the scatter marketplace. Additionally, we sold approximately 32% of Hallmark Movie Channel's available inventory in the 2011/2012 upfront, as compared to 9% in the 2010/2011 upfront.

Following the upfront period, sales of our general rate and direct response inventory are made closer to the timing of the actual advertisement. Advertisers with upfront contracts have an option to terminate their contracts, as well as an option to expand the amount of inventory purchased under the contracts. Hallmark Channel had 8% of upfront inventory terminated under such options during the second quarter of 2012 while Hallmark Movie Channel had 5% terminated under such options during this period. The second quarter 2011 termination options that were exercised represented 10% of the second quarter 2011 upfront inventory sales.

Distribution Agreements

Distribution agreements with multiple systems operators are important because they affect our number of subscribers, which in turn has a major impact on our subscriber fees, the number of persons viewing our programming, and the rates charged for advertising. Our long-term distribution challenge will be obtaining favorable renewals of our major distribution agreements as they expire. Our major distribution agreements have terms which expire at various times from September 2012 through December 2032, inclusive of renewal options. Of these distribution agreements, agreements accounting for approximately 15% of Hallmark Channel subscriber base and 17% of Hallmark Movie Channel subscriber base will expire or be the subject of renewal negotiations prior to December 31, 2012.

The universe of cable and satellite TV subscribers in the United States is approximately 104 million homes. The top 30 cable TV networks in the United States, measured by the number of subscribers, have 90 million or more

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subscribers. It is a mature market with relatively high penetration. According to Nielsen Media Research, at June 30, 2012 Hallmark Channel had 87.4 million subscribers and Hallmark Movie Channel had 47.2 million subscribers.

Demographics

As pay television networks draw audience share, audience demographics (*i.e.*, viewers categorized by characteristics such as age, gender and income) become fragmented. As a result, advertisers are able to target the specific groups of viewers who are most likely to purchase their products by advertising on networks which attract the desired viewer demographic.

We believe that the key demographics for Hallmark Channel are the viewers in the groups Adults aged 25 to 54 and Women aged 25 to 54. The average median viewing age was 58.8 and 58.2 for Hallmark Channel for the second quarter ended June 30, 2011 and 2012, respectively. The average median viewing age was 63.6 and 62.5 for Hallmark Movie Channel for the second quarter ended June 30, 2011 and 2012, respectively. In order to achieve our revenue goals, we need to draw in our target audience.

Revenue from Continuing Operations

Our revenue consists of advertising fees and subscriber fees.

Advertising

We earn advertising revenue in the form of spot or general rate advertising and direct response advertising and paid-programming. During the fourth quarter of 2010, we implemented program schedules that rely upon content that is supported by general rate and direct response advertising, effectively eliminating paid-programming (*i.e.*, infomercials) as a source of revenue. Spot advertisements and direct response advertisements are generally 30 seconds long and are aired during or between programs. Spot advertisements are priced at a rate per thousand viewers and almost always bear the Company's commitment to deliver a specified number of viewers. Our revenue from direct response advertising varies in proportion to the direct sales achieved by the advertiser in response to the advertising. It is sold without ratings or product sales commitments.

Our rates for spot advertisements are generally calculated on the basis of an agreed upon price per unit of audience measurement in return for a guaranteed commitment by the advertiser. We commit to provide advertisers certain rating levels in connection with their advertising. Advertising rates also vary by time of year due to seasonal changes in television viewership.

Revenue is recorded net of estimated delivery shortfalls, or audience deficiency units (ADUs). Whenever spot advertising is aired in programs that do not achieve promised viewership ratings, we issue ADUs which provide the advertiser with additional spots at no additional cost. We

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defer a pro rata amount of advertising revenue and recognize a like amount as a liability for programs that do not achieve promised viewership ratings. When the make-good spots are subsequently aired, revenue is recognized and the liability is reduced. The level of inventory that is utilized for ADUs varies over time and is influenced by prior fluctuations in our under-delivery, if any, of viewers against promised ratings as well as the rate at which we and our customers mutually agree to utilize the ADUs.

We typically sell approximately 40% of our Networks' advertising in the up-front season, generally in June and July of each year, for the last quarter of the same year and the first three quarters of the following year. We hold back a small percentage of our inventory for ADUs and sell the remainder in the spot or scatter market and to advertisers that purchase up-front inventory on a calendar year basis.

Total day means the time period measured from the time each day the broadcast of commercially-sponsored programming commences to the time such commercially sponsored programming ends on that day.

Our networks are broadcast 24 hours per day. The volume of advertising inventory that we have available for sale is determined by our chosen commercial load per hour and the number of broadcast hours in which we air licensed program content. Our need to reserve inventory for the use of ADUs reduces the amount of advertising

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inventory available for cash sales.

We have advertising sales offices in New York, Los Angeles, Chicago, and Atlanta. In addition, we have made significant investments in programming, research, marketing and promotions, all specifically designed to support the sale of advertising time on our Networks.

Subscriber Fees

Subscriber fees are payable to us on a per subscriber basis by pay television distributors for the right to carry our Networks. The fees we receive per subscriber vary with changes in the following factors, among others:

- the degree of competition in the market;

- the relative position in the market of the distributor and the popularity of the network;

- the packaging arrangements for the network; and

- length of the contract term and other commercial terms.

We are in continuous negotiations with our existing distributors to increase our subscriber base in order to enhance our advertising revenue. We have been subject to past requests by major distributors to pay subscriber acquisition fees for additional subscribers or to waive or accept lower subscriber fees if certain numbers of additional subscribers are provided. We also may help fund the distributors' efforts to market our Networks or we may permit distributors to offer limited promotional periods without payment of subscriber fees.

Fees that we pay to distributors are capitalized and amortized over the contractual term of the applicable distribution agreement as a reduction in subscriber fee revenue. At the time we sign a distribution agreement and periodically thereafter, we evaluate the recoverability of the costs we incur against the incremental revenue directly and indirectly associated with each agreement.

Our Networks are usually offered as one of a number of networks on either a basic tier or part of other program packages and are not currently offered on a stand-alone basis. Thus, while a cable or satellite customer may subscribe and unsubscribe to the tiers and program packages in which one of our Networks is placed, these customers do not subscribe and unsubscribe to our Networks alone. We are not provided with information from the distributors on their overall subscriber churn and in what manner their churn rates affect our subscriber counts; instead, we are provided information on the total number of subscribers who receive the Networks.

Our subscriber count depends on the number of distributors carrying one of our Networks and the size of such distributors as well as the program tiers on which our Network is carried by these distributors. From time to time, we experience decreases in the number of subscribers as promotional periods end, or as a distributor arrangement is amended or terminated by us or the distributor. The level of subscribers could also be affected by a distributor repositioning our Networks from one tier or package to another tier or package. Management analyzes the estimated effect each new or amended distribution agreement will have on revenue and costs. Based upon these analyses, if subscriber acquisition fees are needed, management endeavors to achieve a fair combination of subscriber commitments and subscriber acquisition fees.

Cost of Services

Our cost of services consists primarily of the amortization of program license fees, the cost of signal distribution, and the cost of promotional segments that are aired between programs.

Critical Accounting Policies, Judgments and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires the Company to make estimates and assumptions that affect the reported amounts of assets and

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liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

For further information regarding our critical accounting policies, judgments and estimates, please see Notes to Unaudited Condensed Consolidated Financial Statements contained in Item 1 of this Report and Critical Accounting Policies, Judgments and Estimates in Item 7 of the Company's Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2011.

Effects of Transactions with Related and Certain Other Parties

In 2011 and in prior years, we entered into a number of significant transactions with Hallmark Cards and certain of its subsidiaries. These transactions include, among other things, trademark licenses, program licenses, and an administrative services agreement. A summary of the terms and financial impact of these transactions is described in the Company's Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2011.

Selected Historical Consolidated Financial Data of Crown Media Holdings

In the table below, we provide selected historical condensed consolidated financial and other data of Crown Media Holdings and its subsidiaries. The following selected condensed consolidated statement of operations data for three and six months ended June 30, 2011 and 2012, are derived from the unaudited financial statements of Crown Media Holdings and its subsidiaries. Ratings and subscriber information is also unaudited. This data should be read together with the condensed consolidated financial statements and related notes included elsewhere in this Form 10-Q.

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Revenue:										
Advertising	\$	57,914	\$	66,517	15%	\$	113,648	\$	130,379	15%
Subscriber fees		18,132		19,860	10%		35,881		39,658	11%
Other revenue		104		363	249%		216		477	121%
Total revenue		76,150		86,740	14%		149,745		170,514	14%
Cost of Services:										
Programming costs		36,265		34,538	-5%		68,372		68,673	0%
Operating costs		2,941		3,668	25%		5,893		6,737	14%
Total cost of services		39,206		38,206	-3%		74,265		75,410	2%
Selling, general and administrative expense										
Marketing expense		12,902		14,617	13%		29,023		29,320	1%
Income before interest and income tax expense		543		739	36%		893		1,239	39%
Interest expense		23,499		33,178	41%		45,564		64,545	42%
Income before income tax expense and gain from sale of discontinued operations		(1,535)		(11,431)	645%		(3,330)		(23,204)	597%
Income tax provision		21,964		21,747			42,234		41,341	
Income before gain from sale of discontinued operations		(419)		(8,274)	1875%		43,408		(15,598)	-136%
Gain from sale of discontinued operations		21,545		13,473			85,642		25,743	
Net income	\$	189	\$	189		\$	189	\$	189	
Other Data:										
Net cash provided by operating activities	\$	6,948	\$	12,771	84%	\$	14,130	\$	7,951	-44%
Net cash used in investing activities	\$	(461)	\$	(236)	-49%	\$	(701)	\$	(328)	-53%
Net cash used in financing activities	\$	(13,931)	\$	(816)	-94%	\$	(36,920)	\$	(19,126)	-48%
HC day household ratings (1)(3)(4)		0.4		0.4	7%		0.4		0.4	4%
HC primetime household ratings (2)(3)(4)		0.5		0.5	-4%		0.6		0.6	-10%
HMC day household ratings (1)(3)(4)		0.2		0.3	32%		0.2		0.3	13%
HMC primetime household ratings (2)(3)(4)		0.3		0.3	3%		0.4		0.3	-16%
HC day W25-54 ratings (1)(3)(4)		0.2		0.2	16%		0.2		0.2	16%
HC primetime W25-54 ratings (2)(3)(4)		0.3		0.3	7%		0.3		0.3	6%
HMC day W25-54 ratings (1)(3)(4)		0.1		0.1	45%		0.1		0.1	26%
HMC primetime W25-54 ratings (2)(3)(4)		0.1		0.1	18%		0.1		0.1	3%
HC subscribers at period end (4)		87,588		87,424	0%		87,588		87,424	0%
HMC subscribers at period end (4)		41,630		47,191	13%		41,630		47,191	13%

(1) Total day is the time period measured from the time each day the broadcast of commercially sponsored programming commences to the time such commercially sponsored programming ends.

(2) Primetime is defined as 8:00 - 11:00 P.M. in the United States.

(3) These Nielsen ratings are for the time period April 1 through June 30 and January 1 through June 30.

(4) HC represents Hallmark Channel and HMC represents Hallmark Movie Channel.

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Results of Operations

Three Months Ended June 30, 2011, Compared to Three Months Ended June 30, 2012

Revenue. Our revenue from continuing operations, comprised primarily of advertising and subscriber fees, increased \$10.6 million or 14% during the three months ended June 30, 2012, over the three months ended June 30, 2011. Advertising revenue increased \$8.6 million, or 15%, due to the increase in ratings in key demographics. Advertising revenue from Hallmark Movie Channel increased 40% from \$8.2 million to \$11.5 million for the three months ended June 30, 2011 and 2012, respectively.

For the three months ended June 30, 2012, Nielsen ranked Hallmark Channel 19th in total day viewership with a 0.4 household rating and 32nd in primetime with a 0.5 household rating among the 96 cable channels in the United States market. For the three months ended June 30, 2012, Nielsen ranked Hallmark Movie Channel 31st in total day viewership with a 0.3 household rating and 42nd in primetime with a 0.3 household rating among the 96 cable channels in the United States market.

Our subscriber fee revenue increased \$1.7 million or 10% due to rate increases under certain distribution agreements. The amount of subscriber acquisition fees that was recorded as a reduction of subscriber fee revenue was approximately \$298,000 and \$323,000 for the three months ended June 30, 2011 and 2012, respectively.

Cost of services. Cost of services as a percent of revenue decreased to 44% in the three months ended June 30, 2012 as compared to 51% in the three months ended June 30, 2011. This decrease results from the 15% increase in advertising revenue discussed above and a decrease in programming costs discussed below.

Programming costs decreased \$1.7 million or 5% in the three months ended June 30, 2012, from the three months ended June 30, 2011. This decrease was due to the expiration of a number of programming license agreements. These decreases were offset, in part, by the Company writing off two series that are no longer aired on Hallmark Channel. Additionally, the Company recognized \$1.3 million of film asset impairment expense during the second quarter of 2012 due to uncertainty surrounding the future usage of certain film assets.

The Company's salary and severance expense increased \$101,000 for the three months ended June 30, 2012, as compared to the three months ended June 30, 2011, due to the termination of one employee during 2012 and the Company's residual expense increased \$698,000 for the three months ended June 30, 2012, as compared to the three months ended June 30, 2011. Bad debt expense was \$129,000 for the three months ended June 30, 2011, as compared to \$8,000 for the three months ended June 30, 2012.

Selling, general and administrative expense. Selling, general and administrative expense increased \$1.7 million for the three months ended June 30, 2012, over the three months ended June 30, 2011. Employee costs increased \$1.4 million over 2011 primarily due to a \$1.2 million increase in bonus, commissions and long term incentive plan expenses associated with improved financial performance over the same period of 2011. Research expense increased \$110,000 due to growth in Hallmark Movie Channel subscribers. Music rights expense increased \$112,000

due to revenue growth.

Marketing expense. The Company did not have a significant marketing promotion in the second quarter of 2011 or 2012. The Company promoted the original movies *Undercover Bridesmaid*, *Notes from the Heart Healer*, *Kiss at Pine Lake*, *Operation Cupcake*, *Duke*, *Lake Effects* and *Hannah's Law* during the second quarter of 2012. The Company expects its marketing expenses to increase during the second half of 2012 due to the promotion of its original holiday programming.

Interest expense. Interest expense increased \$9.9 million for the three months ended June 30, 2012 as compared to the three months ended June 30, 2011, due to the 2010 Recapitalization and the treatment of this transaction under troubled debt restructuring accounting. Interest expense on the Term A and Term B loans was \$603,000 for the three months ended June 30, 2011. Interest expense on the Notes was \$8.0 million and interest expense on the Term Loan was \$3.0 million for the three months ended June 30, 2012, respectively. Other interest expense decreased

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from \$933,000 in 2011 to \$402,000 in 2012.

Income tax (expense) benefit. The company recorded income tax expense of \$419,000 for the three months ended June 30, 2011. The Company recorded income tax expense of \$8.3 million during the three months ended June 30, 2012. The Company recorded \$297,000 and \$425,000 of income tax expense for estimated AMT for the three months ended June 30, 2011 and 2012, respectively.

Gain on sale of discontinued operations. The terms of our April 2005 sale of the international business require that we reimburse the buyer for certain costs. At the time of the sale, we recorded an estimate of our liability for these obligations and considered the amount in our determination of our loss from the sale of discontinued operations as reported in 2005. During the second quarter of 2011, the Company adjusted its estimate for these amounts. This change in estimate was reflected as a \$193,000 gain on sale of discontinued operations, net of \$4,000 of tax.

Six Months Ended June 30, 2011, Compared to Six Months Ended June 30, 2012

Revenue. Our revenue, comprised primarily of advertising and subscriber fees, increased \$20.8 million or 14% during the six months ended June 30, 2012, over the six months ended June 30, 2011. The \$16.7 million or 15% increase in advertising revenue is primarily due to the increase in ratings for certain of our key demographics. For the six months ended June 30, 2012, Nielsen ranked Hallmark Channel 22nd in total day viewership with a 0.4 household rating and 27th in primetime with a 0.6 household rating among the 96 cable channels in the United States market.

Our subscriber fee revenue increased \$3.8 million or 11% for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011. The amount of subscriber acquisition fees that was recorded as a reduction of subscriber fee revenue was approximately \$596,000 and \$651,000 for the six months ended June 30, 2011 and 2012, respectively. Subscriber revenue increased in the six months ended June 30, 2012, primarily due to contractual rate increases.

Cost of services. Cost of services as a percent of revenue decreased to 44% in the six months ended June 30, 2012, as compared to 50% in the six months ended June 30, 2011. This decrease resulted primarily from the 15% increase in advertising revenue discussed above, offset, in part by the effects of the increases in operating costs, discussed below.

Operating costs for the six months ended June 30, 2012, increased \$844,000 as compared to the six months ended June 30, 2011. The Company's salary and severance expense increased \$304,000 for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011, and the Company's residual expense increased \$761,000 for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011. These increases, were offset, in part, by a \$273,000 decrease in bad debt expense. Bad debt expense was \$301,000 for the six months ended June 30, 2011, as compared to \$28,000 for the six months ended June 30, 2012.

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Selling, general and administrative expense. Selling, general and administrative expense increased \$297,000 for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011. Research costs increased \$687,000 due to growth in Hallmark Movie Channel subscribers and employee costs increased \$1.8 million. The Company recorded non-recurring banking fees attributable to the 2010 Recapitalization of \$2.5 million in the six months ended June 30, 2011.

Marketing expense. Marketing expense increased \$346,000 for the six months ended June 30, 2012, as compared to the six months ended June 30, 2011. The Company promoted the original movies *Cupid*, *Chasing Leprechauns*, *Undercover Bridesmaid*, *Notes from the Heart Healer*, *Kiss at Pine Lake*, *Operation Cupcake*, *Duke*, *Lake Effects* and *Hannah's Law* during the six months ended June 30, 2012. The Company did not have significant marketing promotions in either the six months ended June 30, 2011 and 2012.

Interest expense. Interest expense increased \$19.9 million for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011, due to the 2010 Recapitalization and the treatment of this transaction under

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troubled debt restructuring accounting. Interest expense on the Term A and Term B loans was \$1.4 million for the six months ended June 30, 2011. Interest expense on the Note was \$16.1 million and interest expense on the Term Loan was \$6.2 million for the six months ended June 30, 2012, respectively. Other interest expense decreased from \$1.9 million for the six months ended June 30, 2011, to \$837,000 for the six months ended June 30, 2012.

Income tax (expense) benefit. During the six months ended June 30, 2011, the Company released a portion of its valuation allowance and recognized an unreserved deferred tax asset of approximately \$44.2 million, which also resulted in a non-cash reduction in income tax expense. The Company recorded income tax expense for estimated AMT of \$550,000 and \$811,000 for the six months ended June 30, 2011 and 2012, respectively. This reflects accounting for income taxes on a separate return basis. The Company recorded income tax expense of \$15.6 million during the six months ended June 30, 2012.

Gain on sale of discontinued operations. The terms of our April 2005 sale of the international business require that we reimburse the buyer for certain costs. At the time of the sale, we recorded an estimate of our liability for these obligations and considered the amount in our determination of our loss from the sale of discontinued operations as reported in 2005. During the second quarter of 2011, the Company adjusted its estimate for these amounts. This change in estimate was reflected as a \$193,000 gain on sale of discontinued operations, net of \$4,000 of tax.

Liquidity and Capital Resources

Cash provided by operating activities was \$14.1 million and \$8.0 million for the six months ended June 30, 2011 and 2012, respectively. The Company had net income of \$25.7 million for the six months ended June 30, 2012, as compared to \$85.8 million for the six months ended June 30, 2011. Our depreciation and amortization expense for the six months ended June 30, 2012, increased to \$65.5 million from \$64.9 million while our income tax benefit decreased from \$43.4 million for the six months ended June 30, 2011, to an income tax expense of \$15.6 million for the six months ended June 30, 2012. The Company made programming payments of \$81.6 million and \$87.5 million during the six months ended June 30, 2011 and 2012, respectively.

Cash used in investing activities was \$701,000 and \$328,000 during the six months ended June 30, 2011 and 2012, respectively. During the six months ended June 30, 2011 and 2012, we purchased property and equipment for \$607,000 and \$328,000, respectively.

Cash used in financing activities was \$36.9 million and \$19.1 million for the six months ended June 30, 2011 and 2012, respectively. The Company made principal payments on its Term A and Term B loans of \$23.6 million for the six months ended June 30, 2011. The Company made a dividend payment of \$12.8 million to the Preferred Stockholder during the six months ended June 30, 2011. The Company made principal payments on its Term Loan of \$18.6 million for the six months ended June 30, 2012.

In April 2011, the Company paid Hallmark Cards \$5.1 million under a federal tax sharing agreement relating to income generated in first quarter of 2011, and in July 2011 paid \$5.4 million in respect of the second quarter. The Company paid \$4.4 million in May 2012 and the remaining \$1.0 million was offset against the 2010 overpayment. The Company paid \$6.2 million in respect to the second quarter of 2012 in July 2012.

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The Company's management anticipates that the principal uses of cash during the twelve month period ending June 30, 2013, will include the payment of operating expenses, accounts payable and accrued expenses, programming costs, interest and mandatory principal payments of approximately \$44.7 million under the Term Loan and Notes, and additional principal payments made from excess cash flows, as may become due under the Term Loan. The Company believes that cash on hand, cash generated by operations, and borrowing available under its bank credit facility, will be sufficient to fund the Company's operations and enable the Company to meet its liquidity needs through June 30, 2013.

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Credit Facilities and Term Loan

On July 14, 2011, in connection with the 2011 Refinancing, the Company entered into a new \$240.0 million credit agreement (the Credit Agreement) with the lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent. The Credit Agreement provides for a seven year \$210.0 million senior secured term loan facility (the Term Loan) and a five year \$30.0 million senior secured super-priority revolving credit facility (the Credit Facility). The Term Loan was issued at a discount of 1.0% or \$2.1 million.

At both December 31, 2011, and June 30, 2012, the Company had no outstanding borrowings under the Credit Facility. There were no letters of credit outstanding at December 31, 2011; one letter of credit was outstanding in the amount of \$202,000 at June 30, 2012. Interest expense on borrowings under the Credit Facility for the three and six months ended June 30, 2012, was \$0. Commitment fees on the Credit Facility are payable on the unused revolving credit commitment at the rate of 0.50% per annum, payable quarterly. Commitment fee expense for the three months ended June 30, 2011 and 2012, was \$29,000 and \$38,000, respectively. Commitment fee expense for the six months ended June 30, 2011 and 2012, was \$57,000 and \$76,000, respectively.

The Term Loan was drawn on July 14, 2011, at LIBOR at the Company's election. All LIBOR term loans will bear interest at the LIBOR Rate (subject to a minimum rate of 1.25%) plus 4.50%. The interest rate at both December 31, 2011, and June 30, 2012, was 5.75%.

The provisions of the Term Loan require Crown Media Holdings to make principal payments of \$525,000 at each quarter's end, commencing September 30, 2011, until maturity on July 14, 2018. The Company is required to make additional principal payments in amounts equal to (1) 50% of excess cash flow (as defined in the Credit Agreement) of Crown Media Holdings for the remainder of 2011, and each year thereafter, which percentage will be reduced to 25% if the Consolidated Leverage Ratio (as defined in the Credit Agreement) is equal to or less than 4.25 to 1 but greater than 3.25 to 1, and 0% if the Consolidated Leverage ratio is equal to or less than 3.25 to 1, respectively; (2) 100% of net cash proceeds of dispositions or casualty events if Crown Media Holdings has not invested such proceeds within one year after the occurrence of the disposition or casualty event; and (3) 100% of net cash proceeds from issuance of debt or preferred stock not otherwise permitted by the Credit Agreement.

The covenants in the Credit Agreement limit the ability of Crown Media Holdings and certain of its subsidiaries to (1) incur indebtedness; (2) create or permit liens on assets; (3) make certain dividends, stock repurchases and redemptions and other restricted payments; (4) make certain investments; (5) prepay indebtedness; (6) enter into certain transactions with Crown Media Holdings' affiliates; (7) dispose of substantially all of the assets of Crown Media Holdings; (8) merge or consolidate; (9) enter into new unrelated lines of businesses; and (10) enter into sale and leaseback transactions. The Credit Agreement also requires compliance with a maximum total leverage ratio test and a maximum total secured leverage ratio test, but permits, with certain limitations, certain equity contributions to be made to Crown Media Holdings to enhance its ability to comply with such ratio tests.

The credit facility contains a number of affirmative and negative covenants. The Company was in compliance with these covenants as of June 30, 2012.

The Company made principal payments of \$525,000 and \$18.6 million under the Term Loan during the three and six months ended June 30, 2012, respectively. Interest expense under the Term Loan was \$2.9 million and \$6.2 million for three and six months ended June 30, 2012,

respectively. After giving effect to the amortization of associated debt issuance costs and original issue discount, the effective interest rate of the Term Loan was approximately 6.3% during the six months ended June 30, 2012.

The Notes

On July 14, 2011, also as part of the 2011 Refinancing, the Company issued \$300.0 million in aggregate principal amount of 10.5% Senior Notes, at par, due July 15, 2019 (the Notes) in a private placement conducted pursuant to Rule 144A under the Securities Act of 1933, as amended (the Securities Act). Subsequently, Crown Media Holdings and the Guarantors filed a registration statement with the Securities and Exchange Commission and

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exchanged the Notes for a new issuance of substantially identical notes registered under the Securities Act. The Notes are guaranteed on a senior basis by each of Crown Media Holdings' subsidiaries (the Guarantors).

Commencing January 15, 2012, interest is payable each January 15th and July 15th. The Company is not required to make mandatory sinking fund payments with respect to the Notes.

The covenants in the related indenture limit the ability of the Company to, among other things (1) incur additional debt; (2) pay dividends or make other restricted payments; (3) purchase, redeem or retire capital stock or subordinated debt; (4) make asset sales, including by way of sale leaseback transactions; (5) provide subsidiary guarantees; (6) enter into transactions with affiliates; (7) incur liens; (8) make investments; and (9) merge or consolidate with any other person.

During any period in which the Notes have an investment grade rating from both Moody's and S&P (at least Baa3 by Moody's and BBB- by S&P), and no default has occurred and is continuing under the Indenture, Crown Media Holdings and its restricted subsidiaries will not be required to comply with the covenants in the Indenture that limit their ability to (1) incur additional debt; (2) pay dividends or make other restricted payments; (3) purchase, redeem or retire capital stock or subordinated debt; (4) make asset sales; (5) provide subsidiary guarantees; and (6) enter into transactions with affiliates. The Company was in compliance with these covenants as of June 30, 2012.

Interest expense under the Notes was \$8.1 million and \$16.1 million for the three and six months ended June 30, 2012, respectively. After giving effect to the amortization of associated debt issuance costs, the effective interest rate of the Notes was approximately 11% during the six months ended June 30, 2012.

Risk Factors and Forward-Looking Statements

The discussion set forth in this Form 10-Q contains statements concerning potential future events. Such forward-looking statements are based on assumptions by Crown Media Holdings management, as of the date of this Form 10-Q including assumptions about risks and uncertainties faced by Crown Media Holdings. Readers can identify these forward-looking statements by their use of such verbs as expects, anticipates, believes, or similar verbs or conjugations of such verbs. If any of management's assumptions prove incorrect or should unanticipated circumstances arise, Crown Media Holdings' actual results, levels of activity, performance, or achievements could differ materially from those anticipated by such forward-looking statements.

Among the factors that could cause actual results to differ materially are those discussed in the Company's filings with the Securities and Exchange Commission, including the Risk Factors stated in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, and subsequent Quarterly Reports on Form 10-Q. Such Risk Factors include, but are not limited to, the following: competition for distribution of networks, viewers, advertisers and the acquisition of programming; fluctuations in the availability of programming; fluctuations in demand for programming which we air on our networks; our ability to address our liquidity needs; and our substantial indebtedness affecting our financial condition and results.

Available Information

We will make available free of charge through our website, www.hallmarkchannel.com, the 2011 Annual Report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K, and amendments to such reports, as soon as reasonably practicable after we electronically file or furnish such material with the Securities and Exchange Commission.

Additionally, we will make available, free of charge upon request, a copy of our Code of Business Conduct and Ethics, which is applicable to all of our employees, including our senior financial officers. Requests for a copy of this code should be addressed to the General Counsel at 12700 Ventura Boulevard, Studio City, California 91604.

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Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

We only invest in instruments that meet high credit and quality standards, as specified in our investment policy guidelines. These instruments, like all fixed income instruments, are subject to interest rate risk. The fixed income portfolio will decline in value if interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of June 30, 2012, the decline of the fair value of the fixed income portfolio would not be material.

As of June 30, 2012, our cash, cash equivalents and short-term investments had a fair value of \$23.7 million and were invested in cash. The primary purpose of these investing activities has been to preserve principal until the cash is required to fund operations. Consequently, the size of this portfolio fluctuates significantly as cash is provided by and used in our business.

The value of certain investments in this portfolio can be impacted by the risk of adverse changes in securities and economic markets and interest rate fluctuations. For the six months ended June 30, 2012, the impact of interest rate fluctuations, changed business prospects and all other factors did not have a material impact on the fair value of this portfolio, or on our income derived from this portfolio.

We have not used derivative financial instruments for speculative purposes. As of June 30, 2012, we are not hedged or otherwise protected against risks associated with any of our investing or financing activities.

We are exposed to market risk.

We are exposed to market risk, including changes to interest rates. To reduce the volatility relating to these exposures, we may enter into various derivative investment transactions in the near term pursuant to our investment and risk management policies and procedures in areas such as hedging and counterparty exposure practices. We have not used derivatives for speculative purposes.

If we use risk management control policies, there will be inherent risks that may only be partially offset by our hedging programs should there be any unfavorable movements in interest rates or equity investment prices.

The estimated exposure discussed below is intended to measure the maximum amount we could lose from adverse market movements in interest rates and equity investment prices, given a specified confidence level, over a given period of time. Loss is defined in the value at risk estimation as fair market value loss.

Our interest income and expense is subject to fluctuations in interest rates.

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Our material interest bearing assets consisted of cash equivalents and short-term investments. The balance of our interest bearing assets was \$23.7 million, or 3% of total assets, as of June 30, 2012. Our material liability subject to interest rate risk consisted of our Term Loan. The balance of this liability was \$188.6 million, or 28% of total liabilities, as of June 30, 2012. Net interest expense for the three and six months ended June 30, 2012, was \$11.4 million and \$23.2 million, respectively. Such amounts represented 13% and 14% of our total revenue for the respective periods. Our net interest expense for this liability is sensitive to changes in the general level of interest rates, primarily U.S. and LIBOR interest rates. In this regard, changes in U.S. and LIBOR (Eurodollar) interest rates affect the fair value of interest bearing liabilities.

Our variable rate Term Loan was subject to an interest rate floor of 1.25% and a margin of 4.5% during the three and six months ended June 30, 2012. Accordingly, if the relevant market interest rate had been 1% greater or lower, the effect on the Term Loan s effective interest rate and resulting interest expense for the period would have been negligible.

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Item 4. Controls and Procedures.

a. Disclosure Controls and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

b. Changes in Internal Control over Financial Reporting

There was no change in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2012, that materially affected, or was reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

For information regarding a lawsuit concerning the Company's Recapitalization, please see Note 10 to the Unaudited Condensed Consolidated Financial Statements contained in Item 1 of this Report.

Item 1A. Risk Factors

You should carefully consider the factors discussed in Part I, Item 1A, Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, as such risk factors have been updated by the filing with the SEC of subsequent periodic and current reports from time to time, which factors could materially affect our business, financial condition, or future results. Such risks, however, are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, and/or reporting results.

Item 5. Other Information

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On July 25, 2012, the Company amended the employment agreement with William Abbott, President and Chief Executive Officer of the Company, and extended the term of his employment for an additional two years, through December 31, 2014.

Item 6. Exhibits

INDEX TO EXHIBITS

Exhibit Number	Exhibit Title
3.1	Amended and Restated By-Laws (previously filed as Exhibit 3.2 to our Registration Statement on Form S-1/A (Amendment No. 3), Commission File No. 333-95573, and incorporated herein by reference).
3.2	Second Amended and Restated Certificate of Incorporation of Crown Media Holdings (previously filed as Exhibit 3.1 to our Current Report on Form 8-K filed on March 1, 2010 and incorporated herein by reference).
3.3	Certificate of Designation, Powers, Preferences, Qualifications, Limitations, Restrictions and Relative Rights of Series A Convertible Preferred Stock of Crown Media Holdings, Inc. (previously filed as Exhibit 3.2 to our Current Report on Form 8-K filed on March 1, 2010 and incorporated herein by reference).
10.1*	Amendment to Employment Agreement, effective June 27, 2012, by and between Crown Media Holdings, Inc. and William Abbott.
10.2*	Executive Employment Agreement, dated as of January 1, 2012, by and between Crown Media Holdings, Inc. and Susanne McAvoy.
31.1	Rule 13a-14(a) Certification executed by the Company's Chief Executive Officer.

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31.2	Rule 13a-14(a) Certification executed by the Company's Executive Vice President and Chief Financial Officer.
32	Section 1350 Certifications.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

* Management contract or compensating plan or arrangement.

Furnished, not filed.

XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and is otherwise not subject to liability under these sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CROWN MEDIA HOLDINGS, INC.

	Signature	Title	Date
By:	/s/ WILLIAM J. ABBOTT	Principal Executive Officer	July 27, 2012
William J. Abbott			
By:	/s/ ANDREW ROOKE	Principal Financial and Accounting Officer	July 27, 2012
Andrew Rooke			

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