Less Than Zero
Studio Accounting Practices in Hollywood

By Joseph F. Hart, Esq. and Philip J. Hacker, C.P.A.

Joseph F. Hart is a partner in the law offices of Weinstein and Hart, in Beverly Hills, California. His practice includes intellectual property litigation in the motion picture, television and music industries. He has handled numerous profit participation and accounting cases, primarily on behalf of profit participants and royalty recipients.

Philip J. Hacker is a certified public accountant and a senior partner in the accounting firm of Hacker, Douglas & Company in Los Angeles, California. Mr. Hacker's firm has performed profit participation audits and rendered litigation support services to most major motion picture and television profit participants for the past 25 years. The firm's clients include Art Buchwald, Steven Spielberg, Harrison Ford, James Garner, Dustin Hoffman, Aaron Spelling Productions, William Shatner and Leonard Nimoy.

Summary of Article:

This article discusses the issues that typically arise in the process of examining motion picture accountings rendered to net profit participants. The authors explore both the general legal principles involved and the particular accounting practices which are likely to give rise to disputes between profit participants, on one hand, and motion picture studio/distributors on the other.

The seemingly insatiable thirst of the public for news about the motion picture business has now reached even the arcana of Hollywood's studio accounting practices. The *Coming To America* case, *Art Buchwald v. Paramount Pictures Corp.*(1), garnered widespread notoriety, as it exposed to public light Paramount's accounting procedures, many of which were considered odd by any normal business standards. The trial court in *Buchwald* held that

certain parts of Paramount's standard contractual net-profit definition, as applied in practice, were unconscionable. Paramount appealed the trial court's decision, but ultimately settled the case. Consequently, there is still not any appellate precedent discussing the intricacies of the studio accounting practices.

Despite the settlement in *Buchwald,* many issues raised in that case persist. In fact, in a case involving the motion picture *Batman* and the accounting practices of Warner Bros., another Los Angeles Superior Court judge came to a quite different conclusion, holding that the plaintiffs had failed to prove that the studio's standard-form net-profits contract was unconscionable.(2)

At the heart of these legal disputes is the very meaning of the term *net profit.* Most accountants and business people would define *net profit* as revenue less expenses. Beyond this simple statement, the complexities of certain businesses and the unique nature of various industries demand a special language to explain when revenue is recognized and expenses are incurred. These definitions have been codified by the accounting profession in an information database called *Generally Accepted Accounting Principles* (GAAP).(3)

In addition to GAAP, the accounting profession has developed unique accounting guidelines dealing with standards for particular industries. One such guideline produced for the motion picture industry is entitled *Financial Accounting Standards Bulletin 53* (FASB 53). This guideline discusses when income from the exploitation of a motion picture is to be recognized as earned and when the cost of producing and distributing a motion picture is recognized as incurred.

It is somewhat surprising to the layperson, then, to learn that the reports to net-profit participants by studios do *not* follow GAAP or FASB 53. Instead, these rules are disregarded, and the reported net profit follows a complex document which explains the accounting methodology employed by the studio.

This document generally surfaces as a schedule to the participant's employment agreement containing the studio's *Standard Profit Definition* (SPD). The SPDs used by the various studios have been refined through the years, often in response to issues of interpretation raised by the legal and accounting representatives of profit participants. While the SPDs of the various studios are not identical, they share many common structures and definitions.

The accounting provisions which are contained in the studios' SPDs make it difficult, if not mathematically impossible in many cases, for net profits ever to be achieved. It may be said in jest, although there is a great deal of truth in the statement, that the studios' SPDs are designed *not* to achieve net profits, and therefore, not to pay any share to profit participants, even though the motion picture may have achieved an economic net profit according to GAAP.

The fundamental foundation of GAAP is the accrual method of accounting. The accrual method provides that revenue is recognized when it is earned and expenses are recognized

when they are incurred. In an SPD, the contract language invariably states that revenue will be recognized when the cash is received and expenses will be recognized when they are incurred. This mismatching of revenue and expenses will delay, possibly forever, the reporting of profits, and will also have a significant impact on the computation of interest, an important element in determining net profit.

These accounting practices have spawned a number of legal theories by which attorneys representing net profit participants can challenge the studio SPDs. These include straightforward breach of contract theories, based on the position that the studio's accounting practices do not conform to the contract language of the SPD; unconscionability of the SPD in whole or in part, as was asserted in *Buchwald;* breach of fiduciary duty; and antitrust charges, as has been alleged in a recently filed suit against the major studios. Each of these legal strategies could be invoked by an attorney to challenge one or more of the particular accounting procedures commonly used in SPDs.

The motion picture studios generally provide profit participants with accounting reports which can be divided into three broad categories: (1) receipts, (2) distribution fees and expenses, and (3) production costs. Within those broad categories, profit participants and their representatives will usually find several areas of disagreement with the studio's stated position. In the area of receipts, the disputes commonly concern theatrical gross receipts, home video, television gross receipts, and merchandising and music receipts. Disputes over distribution usually are focused on the areas of advertising, trade show expenses, costs of release prints, taxes, trade dues, and residuals. Production costs are most commonly disputed over the accounting for direct costs, studio overhead charges, overbudget penalties, payments to gross participants, and interest.

Theatrical Gross Receipts. Theatrical gross receipts are least susceptible to reporting manipulation. They are defined simply as the *total proceeds paid by theatres to the distributors for the right to exhibit a motion picture in theaters worldwide.* The typical agreement between the studio/distributor with the motion picture exhibitor provides that a percentage of the box office receipts be paid to the studio. These proceeds are classified as *film rental income* and are accumulated as gross receipts in reporting to the profit participants. Generally, the accounting for this income is reasonable and correct. Failure to account properly in this area would render the studio particularly vulnerable to a claim for breach of fiduciary duty.

It should be noted that the film rental income is different from the box office grosses which are reported in the motion picture trade papers and in the popular media. Those commonly reported figures represent monies received by the exhibitors, and not by the studio/distributors. Thus, when a blockbuster motion picture receives widespread publicity for taking in $100 million at the box office, the film rental income actually received by the studio, and reported to the profit participants, is typically $50 million or less.

Home Video. All the major studios have home video distribution affiliates that sell video cassettes to wholesalers and retailers throughout the world. The SPD for all major

distributors provides that 20 percent of the sums actually received by such affiliated companies will be included in gross receipts. From the remaining 80 percent the studio pays the expenses of marketing and producing the video cassettes, with the exception of residuals, and keeps the profit.

The rationale for the studios' artificial reporting of home video income is merely an historical accident. When home video was in its infancy, and the studios had not yet established in-house home video departments or subsidiaries, the large, independent, home video distributors paid a flat 20 percent royalty to the studios from home video sales. What was left, after expenses, was the profit earned by the independent company. After the studios established their own home video divisions, they continued the practice of reporting 20 percent of actual receipts to profit participants, as if the profits earned by these subsidiaries were not their own.

The trial court in *Buchwald* considered this as one of the potential areas of unconscionability in Paramount's SPD, but inexplicably did not make a finding as to whether the SPD was unconscionable in that regard.(4)

Television Gross Receipts. In recent years television gross receipts has grown dramatically as a revenue source. This market includes U.S. network television, pay and cable television, both premium and basic channels, U.S. syndicated television and foreign television. In each of these markets the licensee negotiates for groups of films from a studio. This type of marketing program is generally referred to as *group* or *package selling.* Since the packages contain pictures ranging from blockbusters to unknowns, the allocation of the receipts for the package purchase price to the individual pictures in the package should be based upon the relative worth of each picture in the package. This seems, however, not to be the case. The poorer performing pictures generally receive an excessively high allocation of a package sale price, with the better performing pictures receiving an allocation that is lower than their relative worth. This practice transfers income from potentially profitable, better performing picture to "dogs" that are in no danger of earning a profit for the studio. Such allocation of television receipts among films brings up a classic contract conflict-of-interpretation issue. The studio argues that the SPD gives it unfettered discretion to allocate receipts from a television package among films, while the profit participant's position is that any allocation must be reasonable, lest it run afoul of the studio's obligation of good faith and fair dealing, which is implied in every contract in California. To date, there has been no appellate determination on this issue, and so it is likely to remain a matter of contention between studios and profit participants.

Merchandising And Music Gross Receipts. All major studios have merchandise-licensing and music-publishing affiliates. The SPD provides for the inclusion of gross receipts from these sources only after the exclusion of up to 50 percent of the gross receipts. Since merchandising and music publishing are becoming increasingly more important as a source of revenue, it is evident that the practice of excluding such a large portion of the gross receipts when accounting to participants has a dramatic impact on the amount of reported profits.

From the participant's perspective, the most likely available legal challenge to the SPD's treatment of merchandising and music income would be based on a theory of unconscionability. In most SPDs, the treatment of music and merchandising income is explicitly stated, and so the likelihood of a claim based upon different interpretations of the agreement is minimal. However, given the apparent lack of any economic justification for reporting less than the full amount of income received from music and merchandising, the clause may well be unconscionable.

Distribution Fees. The SPD provides for a deduction for *distribution fees,* ranging from 15 percent to 50 percent, from each type of media receipt. Although classified as distribution *fees,* this is in effect an extra profit allocation to the studio. The studios' actual distribution overhead -- an average of approximately 12 percent of gross receipts -- is far less than the percentage amounts provided for in the SPD. Deducting such a large percentage *off-the-top* contributes mightily to making it unlikely that a release will ever achieve a net profit according to the SPD definition.

Given the long history of distribution fees, and their inclusion in all SPDs, it appears doubtful that a profit participant would mount a legal challenge to the appropriateness of such charges as a general proposition. There are, however, issues that commonly appear with respect to the classification of income, and the appropriateness of the particular distribution fee being charged, which the attorney and auditor for the participant should be careful to analyze.

Distribution Expenses. The SPD provides for deductions, as distribution expenses, for such items as advertising, release prints, foreign versions, shipping, taxes, trade dues, and checking. Most of these sums charged are bonafide out-of-pocket distribution expenses properly deductible in the determination of net profit. However, many of the charges classified as distribution expenses are not bonafide direct charges.

Advertising. The SPD provides for a percentage (generally 10 percent) to be applied against the direct advertising expenses, ostensibly to cover the studio's advertising "overhead." In the past, studios have had large advertising departments whose primary purpose was to develop and design advertising campaigns. Modern practice generally assigns the development of advertising campaigns to independent contractors, and studio advertising support staffs and overhead have been reduced as a result. Since direct advertising expenditures are growing dramatically (the advertising expenditures for a major release generally exceeds $20,000,000), the practice of adding 10 percent of the direct cost for advertising overhead can reduce the reported net profit by $2 million, or more. This surcharge on advertising expenses was one of the practices that the *Buchwald* trial court found to be unconscionable. The court stated that it "was able to discern no justification for this flat charge and Paramount has offered none."(5)

Trade Show Expenses. Most studios charge the cost of attending sales conventions as an advertising expense. In reality, these are selling expenses and should be covered by the substantial distribution fees provided for in the SPD. (This issue was not addressed in the

Buchwald case.) In practice, the amount of money represented by this particular item is generally too small to impel a claim on its own, but it can become part of the give-and-take negotiations between profit participants and the studios.

Release Prints. All studios have contracts with major laboratories to produce release prints that are used by the theaters to exhibit the picture. A release print costs approximately $1,500, and a national release generally requires 2,000 prints, for a total charge of $3,000,000. While the contracts with the laboratories provide for discounts when certain volume levels are reached, studios do not generally pass these discounts on to the participants in their net profit accountings. This is another item which becomes a subject in settlement negotiations.

Taxes. Taxes charged to a motion picture primarily consist of payments to foreign governments for the right to do business in a particular country. Such taxes can be credited on a one-to-one basis against the studios' United States income tax liabilities, so the studios suffer no net out-of-pocket expense as a result of paying these foreign taxes. Studios insist that the taxes can be legitimately charged against a film, and their inclusion as a distribution expense can reduce net profits by several million dollars. The *Buchwald* trial court, without any discussion, did not find this practice to be unconscionable.

Trade Dues And Checking Costs. Distributors pay dues to certain trade organizations such as the *Motion Picture Association of America* (MPAA). They also engage outside agencies to check on the box office grosses at selected theaters throughout the world. The costs incurred in these activities are allocated to each picture based on the relative film rental income earned. Such allocation of the MPAA dues is especially egregious since it is an industry trade association which promotes the general interest of the motion picture industry. This system is inherently unfair to the more successful pictures since the costs incurred do not relate directly to the amount of revenue generated by each picture. A successful film can receive an expense allocation for trade dues and expenses in excess of $500,000. As in package sales, this is a method for the studios to allocate greater expenses to or reduce the income of the more successful films.

Residuals. Residuals are payments made to talent (actors, directors, writers and musicians) and the technical staff (film crew) for additional uses of the motion picture beyond its initial theatrical use. This expenditure is measured as a percentage of the gross receipts derived from the secondary sources of revenue (television and video). Residuals are payable to the talent as payroll subject to payroll taxes. The studios increase the residual charge by a percentage factor to cover these payroll taxes, but this factor is frequently in excess of the actual payroll tax expense. The studio justification for the artificial payroll tax charge for residuals has traditionally been that the accounting necessary to arrive at a precise figure is too complex an operation for the studio to undertake. Given the increased sophistication of computer-based accounting systems, studios can and should make more precise calculations.

Direct Costs of Production. The SPD contains language that permits the studio to deduct the cost of production *determined in the customary manner producer accounts for*

production cost at the time the picture is produced. (6) A substantial portion of the direct cost of a film produced on a studio lot is charges for the use of the studio's facilities, including the sound stages, vehicles, equipment, etc. Although the studio incurs no out-of-pocket expense for providing these facilities, it insists that the charges are proper because they comply with the SPD language defining production cost. The charges made for using these facilities are substantially in excess of the actual costs. In addition, the studio adds a percentage of the direct labor costs incurred to cover fringe benefits for such items as payroll taxes and union benefits. The percentage applied significantly exceeds the actual fringe benefit expense incurred by the studio. For example, a studio will charge a motion picture for the use of a vehicle at a rental rate based upon the rental rate being charged by the leading rental-car companies, typically $45 per day or more. This charge, which includes a profit rate equivalent to the rental companies' profit rate, will be made even if the vehicle has long ago been purchased by the studio, and even if the cost of the vehicle has been charged against other films. It appears that the *Buchwald* trial court considered this issue, but did not make a finding regarding its unconscionability.(7)

Studio Overhead. The SPD normally provides for a charge of 15 percent of direct production costs to cover studio overhead. Since actual studio overhead is substantially less than the amount permitted to be charged in the SPD, profits are reduced beyond economic reality. The *Buchwald* trial court found Paramount's 15 percent overhead charge to be unconscionable, observing "Paramount's charge of a flat 15 percent for overhead yields huge profits, even though the overhead charges do not even remotely correspond to the actual costs incurred by Paramount."(8) This overhead charge is typically one of the larger items of dispute in any audit of a studio's reporting to its profit participants.

Overbudget Penalty. Most standard profit definitions provide for an additional amount to be added to production cost equal to the amount by which the picture exceeds the original budget estimate. This represents, in effect, a 100 percent penalty charge on any amount spent over the original budget. This practice is especially onerous since the majority of the profit participants do not exercise any control over the decisions that determine whether a picture exceeds its original budget.

As an economic matter, the calculation of whether or not a film has earned profits is completely independent from whether or not the cost of the film exceeded the original budget. A film which costs $25 million to make will be profitable once that $25 million has been earned, and the fact that the original budget was $20 million does not change the fact that the film will begin to earn profits after $25 million has been recouped.

Gross Participations. A few members of an elite club, known as "A-Talent", are able to negotiate profit participations determined solely by the gross receipts earned by the picture. The SPD provides that gross participation payments made before a picture breaks even shall be included as a cost of production, and will therefore be subject to the standard overhead fees and interest charges. What this means is that the production cost (and attendant overhead and interest charges) spiral ever upward as a film becomes more and more successful, ultimately adding millions of dollars to production costs. In many cases this

makes the achievement of net profit a virtual impossibility.

The impact of gross profit participations upon net profit participants is particularly troubling in a situation when the gross profit participant is signed after the net profit participant has already made a deal with the studio. The gross participation can make be the difference between the net profit participant realizing a share of profits or casting the production into a limbo where profitability can never be reached. In such cases, the net profit participant may be able to base a claim on the implied covenant of good faith and fair dealing, arguing that the studio has an obligation not to do anything that is likely to prevent the profit participant from receiving the anticipated benefits under their agreement.(9)

The *Buchwald* trial court was presented with variations of this issue, and made a mixed ruling. The court found that Paramount's practice of charging 15 percent overhead on a "special productions operational allowance" for Eddie Murphy Productions was unconscionable, and it also found that the practice of charging interest on monies paid to gross profit participants was unconscionable, but it made no finding of unconscionability on the general question of whether charging overhead on gross profit participations was unconscionable.(10)

Interest. The SPD provides for the computation of an imputed interest charge based on the unrecouped production cost. The studios apply many factors that cause this interest charge to be inflated beyond the actual interest expense incurred in producing the picture, including: (1) the interest rate charged by the distributor is generally substantially greater than its actual borrowing rate; (2) production costs reported by the studio contain many charges for which the studio does not incur out-of-pocket expenses, and therefore represent no advance of funds; (3) the net receipts applied to recover the production cost contain substantial charges for distribution fees that are not out-of-pocket expenses; (4) gross participation expenses prior to breakeven are included in production cost even though they are only paid after the distributor has obtained gross proceeds from distribution; and (5) distributor first applies the proceeds from distribution to accumulated interest and only after the accumulated interest is satisfied is the balance applied to reduce the unrecovered production cost.

The *Buchwald* trial court found that many of Paramount's practices in charging interest were unconscionable. Specifically, it found that Paramount acted unconscionably in charging interest on the negative cost balance without credit for distribution fees, in charging interest on distribution fees and overhead charges, charging interest on profit participation payments, and charging interest rates not proportional to the actual cost of funds.(11)

Next Page of "Less Than Zero"

ENDNOTES

(1) *Art Buchwald v. Paramount Pictures Corp.,* Los Angeles Superior Court Case No. C706083.

(2) *Batfilm Productions, Inc., et al. v. Warner Bros, Inc., et al.,* Los Angeles Superior Court consolidated Cases Nos.

BC051653 and BC051654.

(3) GAAP contains the standards, conventions, and rules accountants follow in recording and summarizing transactions leading to the preparation of financial statements. GAAP has been developed to standardize the preparation of financial statements so that economic net profit is reported reasonably and consistently.

(4) The trial court in *Buchwald* did not discuss the reasons for its lack of a finding on certain issues raised by the plaintiffs. P. O'Donnell and D. McDougal, Fatal Subtraction, Appendix B (1992) (hereinafter, "Fatal Subtraction"). Fatal Subtraction, a first-person account of the *Buchwald* case which was co-authored by Buchwald's lead counsel, Pierce O'Donnell, reproduces various findings of the trial court as appendices.

(5) *Buchwald,* L.A.Sup.Ct. Case No. C706083, Tentative Decision (Second Phase) reproduced in Fatal Subtraction, *supra,* Appendix B, at 550.

(6) The ability of the studios to unilaterally change their manner of accounting for production costs, and thereby modify the accounting to profit participants is subject to the implied covenant of good faith and fair dealing; the studio must act reasonably in making any changes. *Automatic Vending Co. v. Wisdom* (3d Dist. 1960) 182 Cal.App.2d 354, 357-58, 6 Cal.Rptr. 31.

(7) In its Tentative Decision, the *Buchwald* court mentioned that plaintiffs had challenged "charges for services and facilities in excess of actual costs", but made no further mention of the issue, while finding that certain other practices of Paramount were unconscionable. See Fatal Subtraction, *supra,* Appendix B at 550.

(8) *Id.*

(9) See *Foley v. U.S. Paving Co.* (1968) 262 Cal.App.2d 499, 68 Cal.Rptr. 780 (owners of a company violated the covenant of good faith and fair dealing by increasing their salaries, thereby decreasing company profits, when an employee was entitled by contract to receive a percentage of profits).

(10) Fatal Subtraction, *supra,* Appendix B at 550-51.

(11) *Id*

Copyright 1996, Philip J. Hacker and Joseph F. Hart

Next Page of "Less Than Zero"

Scour Hollywood for Movie memorabilia, books and more!

[Inner Circle || HollywoodInteractive.com || HollywoodNetwork || Hollydex.com || Shopping]

e-mail: HollyInfo@HollywoodNetwork.com

©1996/97 Internet Entertainment Network, Inc. All Rights Reserved.

Less Than Zero
Studio Accounting Practices in Hollywood

By Joseph F. Hart, Esq. and Philip J. Hacker, C.P.A.

continued from page one

Not surprisingly, any number of these accounting practices have been the subject of legal challenge. Perhaps the most basic weapon available to the profit participant is a claim for breach of contract, on the theory that the studio has failed to account properly under the express terms of the SPD. These claims can be broken down further into two major categories: (1) failing to properly itemize an element of cost or income under normal accounting practices, usually a clerical reporting error, and (2) interpreting the SPD in such a manner that favors the studio over the participant. The studios usually make prompt adjustments to resolve the first category of claims. Claims in the second category, however, invariably result in protracted negotiations, or ultimately, litigation.

The second category of breach of contract dispute arises as a result of the studio interpretation of the SPD. Studios will invariably interpret the SPDs in a manner most favorable to their position vis-a-vis the participant, while the participant may find that some of the studio interpretations are not justified by the language of the contract. The participant will have the advantage of arguing the basic contract interpretation rule that, to the extent that the SPD is ambiguous, it must be interpreted most strongly against the party creating the ambiguity.(12)

Since the SPDs have been developed over the years by the studio legal departments, there is little room for the studio to argue that it failed to create the ambiguity. Instead, the studio's defense will usually be either that the contract is not ambiguous, or that "industry custom and practice" mandates that the studio's interpretation be followed. This begs the question as to what is meant by "industry custom and practice." In an industry where the studio interprets SPDs in one manner, and the profit participants and their representatives interpret the SPDs in another manner, there is no single "industry custom and practice" which is accepted by all contracting parties. In any event, there is virtually no reported case law

interpreting the SPDs, and no reported decision that expounds upon motion picture industry's customs and practices.

The breach of contract challenge to the SPD of Paramount Studios in the *Buchwald* case revolved around a theory of unconscionability. Art Buchwald and his partner, Alan Bernheim, sued Paramount Studios for breach of a written agreement to pay for the use of Buchwald's treatment *It's A Crude, Crude World* as the basis for the Eddie Murphy film *Coming To America.* Buchwald's contract with Paramount called for him to be paid a portion of net profits, using Paramount's SPD. The case was tried to Los Angeles Superior Court Judge Harvey Schneider in three phases. In the first phase, the court found that Paramount had used the Buchwald treatment to make *Coming To America;* in the second phase, the court found that portions of the Paramount SPD were unconscionable under California law; and in the third phase, the court awarded damages in favor of Buchwald and Bernheim of $900,000, based upon its reformulation of the contract after finding portions to be unconscionable.

The *Buchwald* court's decision in the unconscionability phase of the trial relied upon the two leading California decisions on unconscionable contracts, *Graham v. Scissor-Tail, Inc.*(13) and *A & M Produce Co. v. FMC Corporation.*(14) In Graham, the California Supreme Court set forth a two-step approach to determine unconscionability. First, the court must establish whether the contract is one of adhesion. Second, assuming that the contract is an adhesion contract, the trial court must determine whether enforcement should be denied, either because 1) the contract, or a provision thereof, falls outside the reasonable expectations of the weaker party; or 2) the contract, or a provision thereof, is unduly oppressive or unconscionable, even though it falls within the reasonable expectations of the weaker party. (15)

In *A & M Produce Co.,* the court held that unconscionability had two elements, a procedural element and a substantive element. The procedural element focuses primarily upon the factors of oppression and surprise. Oppression arises "from an inequality of bargaining power which results in no meaningful negotiation and 'an absence of meaningful choice.'"(16) Surprise is a factor where "supposedly agreed-upon terms of the bargain are hidden in a prolix form drafted by the party seeking to enforce the disputed terms."(17) The substantive element of unconscionability is found when the risks of the bargain are reallocated in an objectively unreasonable or unexpected manner.

The trial court in *Buchwald* made specific findings that the Paramount SPD was an adhesion contract, and that portions of the Paramount SPD were oppressive, and therefore unconscionable,(18) and Paramount appealed. By settling the case before any decision could be issued by an appellate court, Paramount saved itself and the other motion picture studios from a potentially damaging finding which could have resulted in a precedent that many of the clauses in studio SPDs are unconscionable.

Under California law, the issue of unconscionability is a legal issue to be decided by the court prior to submitting any breach of contract claims, which are legal in nature, to a jury.

(19) The court is required to hear evidence as to the "commercial setting, purpose, and effect" of a contract in order to decide if a contract is unconscionable in whole or in part. The court has great latitude in formulating relief if it determines a contract to be unconscionable. The agreement may be enforced in whole or in part, and unconscionable clauses may be interpreted in such a manner as to benefit the profit participant over the studio.(20) The *Buchwald* trial court actually heard the claims for breach of contract prior to making a determination on the issues of unconscionability, a procedure that would presumably not have been available in the event that the plaintiffs had not waived their right to a jury trial.(21)

A more recent case pending in federal district court against all of the major motion picture studios(22), alleges that the SPDs of the major studios are unconscionable and violate California's antitrust laws, as set forth in the Cartwright Act.(23) The lead plaintiff is the estate of former New Orleans district attorney James Garrison, net profit participant under a deal with Warner Bros. for the motion picture *JFK*. The complaint seeks to certify a class of plaintiffs composed of all "Talent"(24) that has entered into a compensation arrangement with a major studio which contains an SPD from January 1, 1988 to the present. Thus, in addition to the typical demurrers that may be anticipated in any case involving studio accounting policies, the plaintiffs in *Estate of Garrison* will face the procedural hurdle of class certification.(25) Assuming that a class is certified, the lawsuit represents perhaps the most serious challenge to date to the major studios' use of SPDs.

In addition to breach of contract, a profit participant may assert a claim that the studio has breached a fiduciary duty to properly account for monies. While in an ordinary contract no fiduciary relationship is created, the contract between a profit participant and studio may in fact create such a relationship, because the studio collects all of the monies from the exploitation of the film product, and is obliged to share in the profits from the exploitation with a profit participant who does not have any involvement in the distribution and collection efforts.

In the case of *Waverly Productions, Inc. v. RKO General, Inc.,* the court noted that a motion picture studio, while not a fiduciary for all purposes, has at least the limited fiduciary duty to properly report to a profit participant for monies received in the course of distributing a film (26). Asserting a claim for breach of fiduciary duty gives the profit participant some additional leverage because the claim sounds in tort as well as contract, and can support an award for punitive damages if the plaintiff can prove wrongdoing by clear and convincing evidence.(27)

Another potential claim, although it has not been asserted in any published decisional, is that the SPDs employed by the major studios constitute an illegal restraint of trade under state or federal antitrust laws. Broadly stated, the Sherman Antitrust Act prohibits all monopolies, contracts, combinations and conspiracies in restraint of trade.(28) Similarly, California's Cartwright Act prohibits any "combination of capital, skill or acts by two or more persons" that "create or carry out restrictions in trade or commerce", or that fix prices so as to preclude free and unrestricted competition. The California courts have held that cases

interpreting the Sherman Act are applicable in interpreting the Cartwright Act.(29) Antitrust laws can be a powerful tool because a plaintiff prevailing under either state of federal law is entitled to recover treble the amount of actual damages sustained, plus attorneys' fees.(30)

As a class action against the major studios alleging antitrust claims under the Cartwright Act (31), it would seem that the plaintiffs in *Estate of Garrison* would be able to establish fairly easily that the six major studios occupy a position of monopoly power with respect to the profit participants involved. While the studios are likely to argue that any single profit participant is not compelled to sign an agreement containing the SPD with any single studio, it is a fact of life in Hollywood that a net profit participant does not have any meaningful alternative in that respect, because all of the major studios use very similar SPDs. The writer, actor, director, or producer who signs a deal with the SPD is invariably presented with a "take-it-or-leave-it" ultimatum from the studio, because the studio knows that the SPDs of the other studios are similar, and will provide nothing better for the artist.

The more difficult issue confronting the plaintiffs in *Estate of Garrison* is proving that the studios have acted in concert in requiring adherence to the SPDs. The studios are likely to argue that they have acted independently in imposing SPDs upon talent, and that their actions are a form of "conscious parallelism", rather than a concerted action. The Supreme Court has held that "conscious parallelism", standing alone, is not definitive proof of a conspiracy under the antitrust laws.(32)

The major motion picture studios have had some negative historical experience with the antitrust laws, most notably the case of *United States v. Paramount Pictures, Inc.*(33), in which the Supreme Court held that a number of the distribution and exhibition practices of the major studios violated the Sherman Antitrust Act, and, inter alia, approved an order divesting the studios from their ownership of theaters. The *Estate of Garrison* case is potentially as important to net profit participants as the *Paramount* case was to independent theater owners.

In addition to these broad-based challenges, interest expenses, alone, could be challenged as a violation of the California usury statutes.(34) The studio might well offer the defense that what is called interest in the SPDs is not really interest subject to the usury laws, because no loan or forbearance of funds is involved. At least one California trial court has sided with the studios on that issue, sustaining a demurrer to that portion of a claim based upon violation of the usury statutes, on the ground that no loan or forbearance was involved in a television net profit participation deal.(35) No appellate court has dealt with the issue. And notwithstanding a ruling that the usury statutes are inapplicable, the profit participant still has the argument available that the interest aspect of the SPD is unconscionable, as the *Buchwald* court, in fact, found.(36)

Whether an appellate court will ever be asked to sort out these issues remains to be seen. As in the Buchwald case, the studios seem intent on settling any dispute out of court before precedent-making law can be issued,(37) and the talent, for the most part, seems willing to go along. So, absent specific direction by an appellate court, disputes over net profits will

continue to be resolved between studios and the participants by strenuous and protracted negotiations, and costly and time-consuming litigation.

First Page of "Less Than Zero"

ENDNOTES

(12) Cal. Civil Code §1654; *Victoria v. Superior Court* (1969) 40 Cal.3d 734, 745, 222 Cal.Rptr. 1, 710 P.2d 833. The rule of interpreting ambiguities against the drafting party has "particular force in the case of the contract of adhesion." *Neal v. State Farm Ins. Co.* (1st Dist. 1961) 188 Cal.App.2d 690, 695, 10 Cal.Rptr. 781. In *Buchwald,* the trial court found that the contract between Buchwald and Paramount was a contract of adhesion, but did not discuss contract interpretation rules, because the issue for decision was whether or not the contract was unconscionable. Fatal Subtraction, Appendix B, at 542-43. The trial court in the *Batfilm* case, L.A.Sup.Ct. consolidated Cases Nos. BC051653 and BC051654, found that the plaintiffs had presented evidence to prove that the agreement between the plaintiffs and Warner Bros. was a contract of adhesion that should be strictly construed against Warner Bros., but found nonetheless that the contract was not unconscionable. The court also found that the plaintiffs had not offered any evidence as to how they expected certain aspects of the contract to be interpreted. See 16 Entertainment Law Reporter Number 4, at 3-6 (September 1994) for the trial court's opinion in *Batfilm.*

(13) *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, 171 Cal.Rptr. 604, 623 P.2d 165.

(14) *A & M Produce Co. V. FMC Corp.* (1982) 135 Cal.App.3d 473, 186 Cal.Rptr. 114.

(15) *Graham, supra,* 28 Cal.3d at 819-20.

(16) *A & M Produce Co., supra,* 135 Cal.App.3d at 486, *quoting, Williams v. Walker-Thomas Furniture Company* (D.C.Cir. 1965) 350 F.2d 445, 449.

(17) *A & M Produce Co, supra,* 135 Cal.App.3d at 486.

(18) Fatal Subtraction, *supra,* Appendix B, at 542-52.

(19) Cal. Civil Code §1670.5; See Legislative Committee Comment -- Assembly 1979 Addition, section 3 (9 West's Annotated California Codes 494 [1985]). *Vance v. Villa Park Mobilehome Estates* (2d. Dist. 1995) 36 Cal.App.4th 698, 42 Cal.Rptr.2d 723.

(20) Cal. Civil Code §1670.5(a).

(21) The trial court in *Buchwald* had ordered the trial bifurcated, with the question of whether Paramount's film was based upon Buchwald's treatment to be tried first to the jury, and the accounting issues to be tried by the court in the event that the jury determined liability. Fatal Subtraction, *supra,* at 218. According to Pierce O'Donnell, lead trial counsel for the plaintiffs in *Buchwald,* the plaintiffs waived a jury trial after considering that a jury would be more likely to be receptive to the testimony of Eddie Murphy, who was anticipated to be a "star" witness for Paramount, and because they were favorably impressed with the independence and intelligence of trial judge Harvey Schneider. Once the case was tried to the judge, Eddie Murphy never testified as a witness for Paramount. *Id.,* at 228.

(22) *Estate of Garrison v. Warner Bros, etc., et al.,* U.S. District Court Case No. CV95-8328. The complaint names as defendants Warner Bros., Inc., Paramount Pictures Corp., Twentieth Century Fox Film Corp., Universal City Studios, United Artists Corporation, Metro-Goldwyn-Mayer, Inc., Sony Pictures Entertainment, Inc., Columbia Pictures, Inc., The Walt Disney Company, Walt Disney Productions, Inc., Touchstone Pictures, Inc., Hollywood Pictures, Inc., Tristar Pictures, Inc., and the trade organization Motion Picture Association of America.

(23) Cal. Business and Professions Code §16700 *et seq.*

(24) The complaint defines "Talent" as "the writers, directors, producers and actors whose ideas and skills create the magic on the screen."

(25) The case was originally filed in Los Angeles Superior Court (Case No. BC139282 [Nov. 17, 1995], but was removed to the United States District Court for the Central District of California, under the Labor Management Relations Act Section 301, 29 U.S.Code §185. It has been assigned to Hon. Robert M. Takasugi.

(26) *Waverly Productions, Inc. v. RKO General, Inc.* (2d Dist. 1963) 217 Cal.App.2d 721, 731-734, 32 Cal.Rptr. 73. *Waverly* involved a dispute between the producer and the studio/distributor of the motion pictures *Enchanted Island* and *From The Earth To The Moon.*

(27) Cal. Civil Code §3294.

(28) 15 U.S.Code §1.

(29) *Bert G. Gianelli Distributing Co. v. Beck & Co.* (1st Dist. 1985) 172 Cal.App.3d 1020, 1042, 219 Cal.Rptr. 203; *Marin County Bd. of Realtors, Inc. v. Palsson* (1976) 16 Cal.3d 920, 925, 130 Cal.Rptr. 1.

(30) Cal. Business and Professions Code §16750(a). (Cartwright Act). 15 U.S.Code §15(a). (Sherman Act). The availability of attorneys' fees in an antitrust claim is significant, because it avoids one of the problems involved in most claims involving net profits, namely, that the SPDs do not contain a reciprocal attorneys' fees provision, and profit participants must usually bear their own attorneys' fees, even when they are successful.

(31) *Estate of Garrison v. Warner Bros, etc., et al.,* Los Angeles Superior Court case no. BC139282; see text at notes 13-16 *supra.*

(32) *Theatre Enterprises, Inc. v. Paramount Film Distributing Corp.* (1954) 346 U.S. 537, 541-43, 74 S.Ct. 257, 260-61.

(33) *United States v. Paramount Pictures, Inc.* (1948) 334 U.S. 131, 68 S.Ct. 915, 92 L.Ed.2d 1260.

(34) California Constitution, Article 15, Section 1 provides that the interest rate for a loan or forbearance of any money "shall not exceed the higher of (a) 10 percent per annum or (b) 5 percent per annum plus the rate prevailing on the 25th day of the month preceding the earlier of (I) the date of execution of the contract to make the loan or forbearance, or (ii) the date of making the loan or forbearance established by the Federal Reserve Bank of San Francisco on advances to member banks. . . ." California Civil Code Sections 1916-1, 1916-2, and 1916-3, uncodified provisions of Stats. 1919, p. lxxxiii, provide further limitations upon the allowable interest rates which may be charged, and provide treble damages for interest improperly charged.

(35) *DeGuere v. Universal City Studios, Inc.,* Los Angeles Superior Court case no. BC 061389 (Aug. 4, 1992). The case involves a net profit participation contract on the long-running television series *Simon & Simon,* brought by writer-producer Philip DeGuere. Under Universal's accounting methodology, interest on production costs totaled $76,371,441 through June 30, 1994. This has resulted in a deficit of $62,723,795 being reported to DeGuere, on reported gross receipts of $317,330,941.

(36) See *Carboni v. Arrospide* (1st Dist. 1991) 2 Cal.App.4th 76, 2 Cal.Rptr.2d 845, applying the doctrine of unconscionability to a loan transaction which was exempt from the usury laws because the lending party was exempt from application of the usury laws by reason of being a licensed real estate broker.

(37) According to the authors of Fatal Subtraction, Lew Wasserman, then chairman of MCA/Universal, told friends that Paramount should not have allowed the *Buchwald* decision to happen, and "should have paid Buchwald the five dollars" (meaning $5 million). Fatal Subtraction, *supra,* at 470.

Copyright 1996, Philip J. Hacker and Joseph F. Hart

First Page of "Less Than Zero"
About Joseph Hart & Philip Hacker