

Incentive Contracts in Entertainment

Is it Gross to Get Net?

Summary

- ◆ Overview of Incentive Contracts in General
- ◆ What Do Incentive Contracts in the Motion Picture Business Look Like
- ◆ How Can We Explain Incentive Contracts in the Motion Picture Business
- ◆ Evidence From Other Entertainment Industries

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Why Did G-d Make Incentive Contracts?

- ◆ Why Is This a Puzzle?
- ◆ Explanations

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Why Is This a Puzzle?

- ◆ Risk Averse Agents Must Get Higher [Expected] Pay to Take on Risk
- ◆ Shareholders Are Diversified So [for This Purpose] Are Risk Neutral--won't Pay to Avoid Risk
- ◆ Managers That Are Too Risk Averse Don't Behave in Shareholder's Best Interest

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Explanations for Incentive Contracts

- ◆ Incentives
- ◆ Asymmetric Information
- ◆ Agency Problems Within the Firm

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Incentives

- ◆ Agents Work Harder If They Can Get More Money by Working Harder
 - Either Cannot Contract on Effort
 - Or Monitoring Costs Are Greater Than Costs Imposed by Risk Aversion of Agents
- ◆ This May Make Managers Too Risk Averse
- ◆ Task Allocation
 - If Agent Works on Many Things, Want to Incentivize Her to Work on Your Thing

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Asymmetric Information

- ◆ One Side to a Bargain Is Informationally Advantaged. Say One Side Has Information About Size of the Market, or Manager Has Private Information About His Quality

- ◆ Incentive Contracts Can Do Two Things
 - Induce Party With Information to Reveal
 - Protect Party W/O Information

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Agency Problems

- ◆ Managers Want to Pursue Their Own Agenda

- ◆ Managers Don't Own All of the Firm So Don't Bear All the Cost of Their Agenda Deviates From Value Maximization [Say They Like to Play Golf]

- ◆ It Is Both Difficult and Costly to Stop Managers From Pursuing Their Own Agendas

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Profit Sharing Contracts in Hollywood

- ◆ Two Generic Types

- ◆ Much Confusion

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Two Generic Types



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Two Generic Types

◆ Gross Receipts

◆ Net Profits

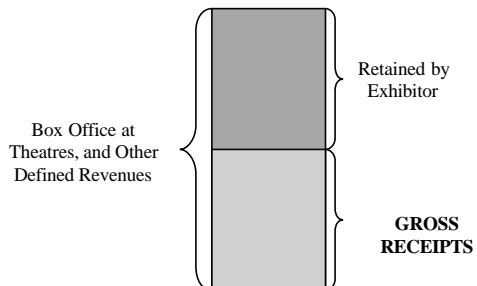
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Gross Receipts

- ◆ Share of Revenues to Studio After Some Point
- ◆ Sometimes (If a Big Star) From First Dollar
- ◆ Sharing Point May Depend on Cost of Movie
- ◆ Almost Always Some Fixed Component of Compensation
- ◆ Like Compensating a Salesman on Sales

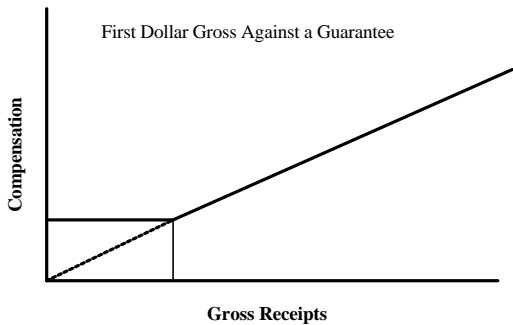
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Gross Receipts



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Payoff on Gross Receipts Contract



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Net or "Net Profits"

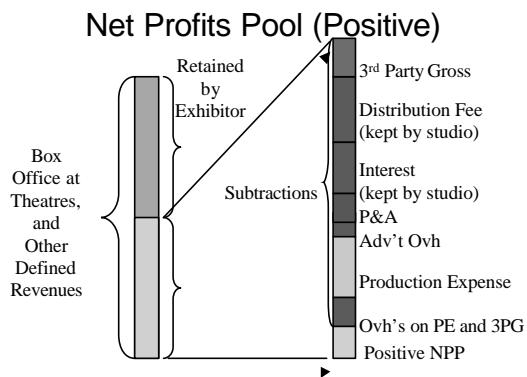
- ◆ This Is Subject of Much Litigation
- ◆ Talent Gets a Percentage of a Bonus Pool
- ◆ Bonus Pool Defined by Revenues Less Certain Allowed Costs
 - Direct Production Expense
 - Prints and Advertising
 - Overhead
 - "Interest" Expense
- ◆ Like Compensating a Salesman Based on Profit Firm Ends up Making From Products He Sold

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“Net Profits”

- ◆ The Modern Net Profits Contract
 - Not GAAP Accounting
 - *Contractually Defined Term*
- ◆ History
- ◆ Litigation

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Structure of Modern NP Contract

- ◆ Fixed Salary Plus
- ◆ % Of “Net Profits” Pool
 - % May Be Reduced by Other Shares
 - Will Be a Floor

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Studio Gets Revenues From Exhibitors

- ◆ Also Counts 80% of Videos
- ◆ Also Counts TV Revenue
- ◆ Studio Gets to Recover Certain Amounts Before NP Pool Is Positive

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Subtractions

- ◆ Cost of Making the Movie
 - Cost of Soundstage, Etc. [From a Rate Card]
 - Salaries
- ◆ Overhead [Will Return to This]
- ◆ Prints
- ◆ Advertising
 - Overhead on Advertising
- ◆ Interest Charge Until Costs Are Recovered
- ◆ Third Party Gross Participations

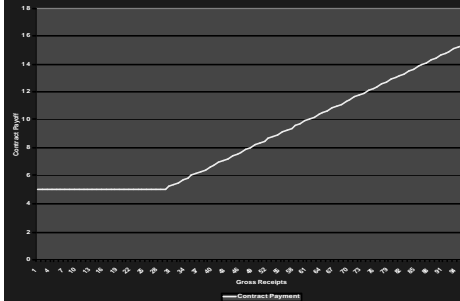
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Independent Movie Paradigm

- ◆ What Would You Have to Do to Make a Movie on Your Own?
 - Raise Money to Finance the Movie
 - Lay Out Some Money for a Screenplay, Etc.
 - Rent Soundstages
 - Hire Talent
 - Get Prints Made
 - Distribute the Movie
 - Advertise the Move
- ◆ When Would You See a Profit?
 - Only After You Have Recovered All These Costs

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Payoff on a Net Profit Contract



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Much Litigation

◆ 2 Approaches to Challenge the Contract

– The Contract Is Unconscionable

- ✦ *Buchwald*
- ✦ *Batfilm*

– The Contract Is Collusive

- ✦ *Garrison*

◆ One Problem Is Use of Phrase “Net Profits”

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“Net Profits”

◆ This Is *Not* GAAP Accounting

– I.E., Not FASB 53

◆ This *Is* a Contractually Defined Term

– Every Contract Has a Rider Attached to It Giving Detailed Definition of How Net Profits Is Derived

◆ When Does This Phrase First Appear

- Most Think 1950 “Winchester ‘73” [Stewart’s Agent Was Lew Wasserman, Ed Muhl Ran BA at Universal]
- Actually Phrase Is Used in 1923 Contract Between David Belasco and Warner Brothers for “Tiger Rose”

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An Unconscionable Legal Detour

- ◆ What Is This Thing Called Unconscionability?
 - Not All Contracts May Be Enforced
 - A Contract May Be So One Sided That It Is Deemed Not Enforceable
 - ❖ Williams v. Walker-Thomas Furniture
 - ❖ Defect May Be in Substance of Contract
 - ❖ Defect May Be in Negotiation Procedure
 - Requires Much More Than Just a Difference in Bargaining Power
 - ❖ Graham v. Scissor-Tail

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Buchwald (and Bernheim) v. Paramount - "Coming to America"

- ◆ Phase 1: Was Movie a Rip off of Buchwald's Idea?
 - Yes, but Not Fraud
 - Enforce Contract
 - ❖ Leads to No Money, Movie Not Yet in Net Profits

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Buchwald Phases 2 & 3

- ◆ Is Net Profits Contracts Unconscionable?
- ◆ Judge Schneider Says Yes
 - Orders Hearing on Damages (Phase 3)
- ◆ Damages Much Smaller Than Buchwald Wanted
- ◆ Appeal Settled, Lower Court Ruling Vacated

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What Is Wrong With the Contract?

- ◆ Overhead Charged on Gross Participations
 - Why Should Paramount Get Overhead Just for Writing a Check
- ◆ Interest Charge Not Related to Paramount Cost of Funds
 - Depends on Prime Rate
- ◆ Overhead Not Directly Related to Actual Overhead Expenses
 - Figured As a Percentage of the Direct Expenses
- ◆ A Few Other Things

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What Arguments Were Not Made?

- ◆ Paramount Must Make a Lot of Money on the Few Good Movies It Has Each Year to Cover the Fact That Most Movies Don't Make Money
 - Perhaps Paramount Did Not Want to Open Its Books
- ◆ Even If the *Definition* of Net Profits Is Unfair, Talent Negotiates for Up-front Money and This Takes the Definition Into Account
 - This Is a Legal Point, Law Lets Judge View Each Contract Term on a Stand-alone Basis

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Batfilm v. Warner Brothers

- ◆ Suit Brought by Those Who Control Movie Right to "Batman"
 - Main Plaintiff Is Ben Melniker
- ◆ Judge Rules for Warners
- ◆ Note That Melniker Spent a Long Time As Head of Business Affairs at Metro
 - He Negotiated a Lot of These Contracts
 - ❖ Claims His Were "Fair"
 - ❖ Cites *Dr. Zhivago*
 - ❖ Problem, DZ Contract Is Even More in Red Than His

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Garrison v. Studios

- ◆ Class Action Anti-trust
- ◆ Named Plaintiff Is Estate of Jim Garrison
 - DA of New Orleans
 - Basis for “JFK”
 - Estate Is Net Participant

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Garrison v. Studios

- ◆ New Approach
 - Anti-trust
 - ✦ Studios Collude by Adopting Unconscionable Net Profit Definition
 - Question
 - ✦ Is This a Reasonable Way to Make Money?
- ◆ Other Explanations for Similar Contract Definitions
- ◆ Current Status

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History of Contracts

- ◆ Common Belief Is That There Were No Sharing Contracts During the Studio Era, but This Is Wrong
- ◆ Some Gross Contracts
 - John Barrymore at Warners in 1930 (First Dollar)
 - Jolson at Warner's (After Certain Box Office)
 - Mae West at Universal (Gross After Box Office Reaches Multiple of Production Costs)for “My Little Chickadee”

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History of Contracts

- ◆ Some Examples of Net Type Contracts
- ◆ Belasco at Warner's in 1923
 - WB Accountant Determines Overhead Costs
 - Fixed Distribution Fee
- ◆ Cagney, Hal Wallis, Errol Flynn, Bette Davis at Warner's in 1940's
 - Distribution Fee and Production Expenses Taken off Including Overhead, but Not Interest

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History of Contracts

- ◆ Contracts Become Much More Common After End of Studio Era
 - Lots of 50-50 After 2x Negative Cost
- ◆ Eventually Come to Modern Contract
 - Paradigm of Modern Contract
 - Producer Has Idea for Movie
- ◆ Compare Net Contract With Self-financing
 - Assume, for Sake of Argument, All Charges at Market
- ◆ Then NP Contract Is Same As Doing It Yourself Except You Don't Get Entire NP Pool

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But There Are Advantages to Using a Studio

- ◆ Non-Recourse, Low Rate Financing
- ◆ One Stop Shopping
- ◆ Better Contract Terms With Talent

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Look at Specific Items Schneider Complains About

- ◆ Overhead on Gross Participation Payments
 - Look to Scale of Production
- ◆ Fixed Overhead
 - Makes Contract Auditable
- ◆ Interest Charge
 - Advances to Movies Not Like Loans to Studio
 - Really Want Cost-of-capital, but Cannot Observe
 - Indie Couldn't Borrow That Cheap on a Non-recourse Basis

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Why Do We See These Contracts?

- ◆ Rip Off Theory
 - Give Me a Break
 - Makes No Sense
 - ✦ Long History of These Contracts
 - ✦ Studio Could Capture All Talent by Offering Slightly Better Terms
- ◆ Incentives
 - ✦ Hard to See in Era of One-off Deals When Market Provides Discipline
 - Look at Raquel Welch Litigation

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Why Do We See These Contracts?

- ◆ Agency Problem
 - These Contracts Let Studio Convert Fixed to Variable Costs
 - Good for Managers Who Are Risk Risk-averse
 - Good for Studio Head Working in Fixed Budget
 - Predicts More Contracts When Output Is Riskier or When Studios Are in Trouble Financially
 - ✦ Consistent With Increased Use after 1946
 - ✦ Consistent With Increased Use at Weaker Studios

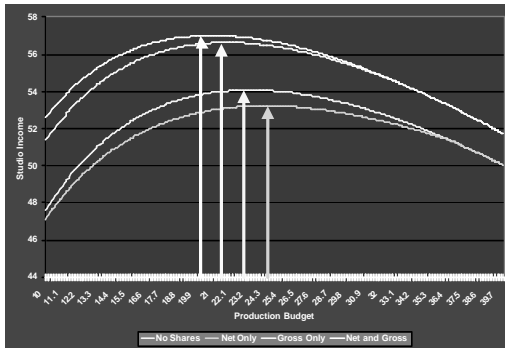
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Potential Effect of Contracts on Production Budgets

- ◆ Studio Will Spend More on “Star Power” and “Production Values”
 - Some of Benefit From Increased Star Comes From Net Participants
 - Net Participant May Be Better off If Star Gets Gross Rather Than Fixed Salary
 - ❖ If Star Is on Fixed Salary Studio Spends More on FX but Gets Full Benefit (Less a Little Bit Given to NP)
 - ❖ If Star Is Getting % of Gross, Studio Bears Costs but Doesn't Get Full Benefit, So Will Spend Less

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Effect of Contract Form on Budget



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What Should We See?

- ◆ Few Payments to Net Players
 - Existence of Net Players Increases Budgets and Reduces Net Pool
 - Net Players Know This, So Attach Little Value to Net Participation Points
- ◆ Like Louis in *Casablanca*, “Rick Pretends to Give Me a Bill, and I Pretend to Pay It”
- ◆ In Reality Studios Don't Know for Sure What Will Happen
 - These Effects Are Mitigated As They May Be Overspending on Their Own Dime

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Should See Some Positive Payments to Net Players

- ◆ This Is, in Fact, What We See
- ◆ This Does Not Mean a Rip-off, Talent Knows the Game and Looks to Up-front Money

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Evidence From TV

- ◆ TV Contract Form Is Like (Sort Of) Movies
 - Comes From Movies, Not Surprising
 - TV Replaces B (and Run of the Mill A) Movies
- ◆ Relatively Little Sharing by Talent (Except)
- ◆ Production Company Has What Looks a Like a Net Deal

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Records

- ◆ Very Different From Movies
 - Talent Gets Fixed Sum to Make Record
 - Can Pocket What Is Left Over
 - If Record Does Not Meet Standards May Have to Redo on Their Own Dime
 - ◆ Technical Standard
 - ◆ Content Standard
- ◆ This Contract Looks a Lot Riskier Than Movie Contract
 - Low Fixed Payment
 - High Variable Component

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Records

- ◆ Why Does Recording Talent Bear So Much Risk?
 - Simpler Process, Act Is Equivalent of (Writer, Cast)
 - Since Success or Failure Concentrated in Fewer Hands, Can Get Those Hands to Take Risk

- ◆ More Clearly an Incentive Rationale for This Contract
