

# GUIDE TO DEAL STRUCTURES

## A. DEFINITIONS

Financially, all that separates two films with identical revenues and costs is the deal with each film's talent. If no contingent payments (participations) are involved, then analyzing a film deal merely involves making revenue and cost estimates and adding and subtracting. However, virtually all films produced today include some form of contingent compensation. Therefore, an understanding of the deal-making process requires an understanding of participation structures.

Contingent compensation deals vary widely in detail, but all have one element in common: a "break-even" point. Break-even occurs when revenues (as defined for a given participant) equal costs and/or charges (also as defined for that participant). "Break-even" may be a fixed dollar amount, a "cash break-even," an "actual break-even," or "first net profits." Therefore, some definitions are necessary.

TOTAL REVENUE - All revenues received by a studio from all markets with respect to a particular film.

HOME VIDEO ROYALTY - The percentage of total home video revenue which the studio reports to contingent participants. The standard studio home video royalty is 20%, although this is negotiable at some studios for certain talent.

GROSS RECEIPTS - The total revenues received by the studio and reported to the participant. The difference between GROSS RECEIPTS and TOTAL REVENUE is due to the HOME VIDEO ROYALTY.

OFF-THE-TOPS (OTTs) - Conversion costs, checking costs, collection costs, residuals, trade dues, licenses, and taxes. These are sometimes referred to as "1-7's," based on the numbering of deductions in studio gross profit exhibits.

ADJUSTED GROSS RECEIPTS (AGR) - GROSS RECEIPTS less OTT's. Gross participants, with very rare exceptions, receive a percentage of adjusted gross receipts. Sometimes referred to as Gross Proceeds ("GP").

DISTRIBUTION FEE - A straight percentage by which revenue is reduced before that revenue is applied against hard costs. Standard (or full) distribution fees vary by market and range from 15% to 50%.

PRODUCTION (STUDIO) OVERHEAD - A flat charge, around 15%, on the production cost of a film. Production overhead is included when calculating participant break-evens. The purpose of this charge is to cover the administrative costs of running a studio, which are not included in direct production cost.

ADVERTISING OVERHEAD - A flat charge, usually 10%, on the advertising costs of a film. Ad overhead is included in distribution costs when calculating participant break-evens. Analogous to production overhead, this is designed to cover administrative costs in the studio marketing department.

INITIAL ACTUAL BREAK-EVEN (ABE) - That point in time when the gross receipts of a film (on a cash basis) equal the sum of the following:

- Full studio distribution fees on revenues;
- Distribution expenses incurred by the studio, including OTT's and advertising overhead;
- Negative cost, which includes gross participations paid up to the point of ABE;
- Studio overhead on negative cost as defined above;
- Interest on unrecouped negative cost and overhead as defined above;
- Any deferrals payable at ABE or out of first net profits.

Note that initial actual break-even is defined as the point at which net profits are first payable.

CASH BREAK-EVEN (CBE) - That point in time when the gross receipts of a film (on a cash basis) equal the sum of the following:

- Defined distribution fees on revenues (i.e., in lieu of lull fees, 12.5%, 15%, etc.);
- Distribution expenses incurred by the studio, including OTT's and advertising overhead;
- Negative cost, which includes gross participations paid up to the point of CBE;
- Studio overhead on negative cost as defined above;
- Interest on unrecouped negative cost and overhead as defined above;
- Any deferrals payable at CBE.

NET PROFITS - What remains of gross receipts after deducting the following:

- Full studio distribution fees on revenues;
- All distribution expenses, including OTT's and advertising overhead;
- Negative cost, as defined for initial ABE;
- Studio overhead on negative cost as defined above;
- Interest on unrecouped negative cost and overhead as defined above;
- Any deferrals payable at ABE or out of first net profits.
- All gross participations paid after ABE.

ROLLING ABE - A break-even which is recalculated every statement to take into account additional distribution expenses incurred after initial ABE. A participant receiving a percentage of gross after rolling ABE receives a percentage of what remains of total gross receipts after deduction of i) revenues to initial actual break-even; ii) distribution expenses and deferrals incurred after initial ABE; and iii) full distribution fees on gross receipts necessary to cover those expenses and deferrals. For example, if total gross receipts are \$200, initial ABE occurred at \$ 100, post-ABE costs are \$21 and the distribution fee is 30%, rolling ABE would be calculated as follows:

|  |          |
|--|----------|
| Revenues to Rolling ABE:                               | \$130    |
| Less: Revenue to Initial ABE                           | 100      |
| Distribution costs after ABE                           | 21       |
| Distribution fees on revenues to cover costs after ABE | <u>9</u> |
| Balance  | \$0      |

So rolling ABE, on this statement, requires \$130. Gross after rolling ABE would be \$200

- \$130= \$70; shares would be calculated on that \$70 amount.

Note that OTT's are included in distribution costs after initial ABE. Therefore, shares of gross after rolling ABE are of pure gross, not adjusted gross.

SOFT FLOOR - Applies to the participant (usually the producer) whose participation is reduced by other contingent participants. The soft floor is a percentage of the revenues this participant receives. If third party participations borne by this participant reduce his/her participation to the soft floor, than participations beyond that point (i.e. which would take the bearing participant below the soft floor) are borne in some fashion by both the studio and the reduced participant. In some cases, additional participations are subtracted not from that participant's share, but "off-the-top" from the pool of revenues on which that participants share is calculated. In others, the studio bears the next X% of participations, the participant bears the next X% after that, and so on.

This is a confusing concept. The most important thing to remember is that once someone reaches their soft floor, the burden of additional participations is shared between the participant and the studio.

HARD FLOOR - Also applies to the participant whose participation is reduced by other contingent participants. The hard floor, like the soft floor, is a percentage of the revenues this participant receives. However, unlike the soft floor, the hard floor is a strict minimum below which a participant may not be reduced.

DEFERMENT - A contingent payment, made at some break-even point. Most deferments are payable at actual break-even or first net profits. Some are payable at a cash break-even, and some are payable at a fixed level of gross or adjusted gross receipts.

MULTIPLE - A factor by which either negative cost or distribution costs are multiplied to reach a breakeven point. Usually applied to negative cost, in which case the multiple includes some combination of overhead, interest, and participations to the multiple, either counted once or multiplied by the multiple factor. Multiples resemble cash and actual break-evens in that they are sensitive to changes in certain costs, but a negative cost multiple is unaffected by distribution costs, and vice-versa.

ARTIFICIAL BREAK-POINT - A fixed level of gross receipts (or adjusted gross receipts) which triggers a gross participation. It is "artificial" because it is not affected by changes in costs, whereas CBEs and ABE are sensitive to cost changes and pre-break participations.

ADVANCE - The amount paid to a participant during production that is subtracted from that participant's first contingent participation. Advances usually apply to participants who receive a percentage of gross from first dollar.

GROSS PARTICIPANT - A participant who receives a percentage of gross or adjusted gross receipts, either from CBE, ABE, first dollar, a multiple, or an artificial break-point.

NET PARTICIPANT - A participant who receives a percentage of net profits.

With those definitions in mind, it is time to summarize the most common deal structures.

## **B. STANDARD DEAL STRUCTURES**

There are two basic kinds of participants in a film's revenue flows: net and gross. There are an infinite number of ways to alter the deals that follow, but as described, they cover a vast majority of the deals currently made.

NET DEAL - The participant receives a percentage of the net profits of the film, as defined above. What most writers and first-time directors get.

GROSS AFTER CBE - The participant receives a set percentage of adjusted gross receipts after CBE, which can have any defined distribution fee percentage. Often a CBE participant has his/her gross percentage increase at CBE with a higher distribution fee, or at ABE.

POST-ABE GROSS - The participant receives a set percentage of adjusted gross receipts after initial actual break-even. In some cases that percentage escalates once a fixed amount of revenues are received after ABE. Note that this participant does not receive money any sooner than a net participant; however, other gross deals and costs after initial ABE do not affect gross participants, whereas they do affect net participants.

POST-ROLLING ABE GROSS - The participant receives a set percentage of gross receipts after Rolling ABE (as defined above). This deal is less lucrative than post-ABE gross, because distribution costs after initial ABE are deducted from gross receipts, but it is more lucrative than net profits, because distribution fees are charged only on the revenues necessary to cover post-ABE distribution costs. See the definition I example above.

GROSS AFTER AN ARTIFICIAL BREAK - The participant receives a set percentage of adjusted gross receipts after gross receipts or adjusted gross receipts reach a specified dollar amount (e.g., 10% of agr after \$80 million of agr). These deals can escalate, starting at the artificial break and increasing either at another artificial break-point, a multiple, CBE, or initial ABE.

GROSS FROM A MULTIPLE - As the name implies, a percentage of adjusted gross receipts after a multiple. These deals can escalate at another multiple, at some CBE, or at initial ABE.

FIRST DOLLAR GROSS - The participant receives a percentage of gross from the first dollar received by the studio. Anyone with the power to make this kind of deal usually receives significant compensation up front, which is considered an advance against later participation. Therefore, this deal is really the same as gross after an artificial break, where the artificial break-point is equal to the advance divided by the participation percentage. For example, a \$5 million advance against 10% of agr is the same as 10% of agr starting at \$50 million of agr;  $\$5.0 \text{ million} \times 1.1 = \$50 \text{ million}$ . Arnold Schwarzenegger, for example, receives first dollar gross (and a hefty advance).

Talent invariably start their careers receiving either a small percentage of net profits or no contingent compensation at all. As they get more work and are more in demand, or are considered somehow responsible for successful movies, the value of their basic and contingent compensation increases incrementally (in most cases) or astronomically (Macaulay Culkin, Julia Roberts).

Stars, like Tom Cruise, Kevin Costner, Tom Hanks, and Harrison Ford (yes, it's mostly men) are the most likely to receive stratospheric deals: basic compensation in excess of \$15 million against first dollar grosses of 10% - 20%. Often these escalate into the 25% - 35% range. Aberrations include director Steven Spielberg and producer George Lucas.

There are some notable exceptions, but writers rarely get anything other than net profits. The best writers usually get more money up front in addition to the 5% of net profits that is standard for sole screenplay credit.