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

Why Did G-d Make Incentive Contracts?

◆ Why Is This a Puzzle?
◆ Explanations
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

Explanations for Incentive Contracts

- Incentives
- Asymmetric Information
- Agency Problems Within the Firm

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
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

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

Profit Sharing Contracts in Hollywood

- Two Generic Types

- Much Confusion
Two Generic Types

- Gross Receipts
- Net Profits

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
Gross Receipts

Box Office at Theatres, and Other Defined Revenues
Retained by Exhibitor

GROSS RECEIPTS

Payoff on Gross Receipts Contract
First Dollar Gross Against a Guarantee

Compensation
Gross Receipts

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
"Net Profits"

- The Modern Net Profits Contract
  - Not GAAP Accounting
  - Contractually Defined Term

- History

- Litigation

Net Profits Pool (Positive)

Structure of Modern NP Contract

- Fixed Salary Plus

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

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

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
Payoff on a Net Profit Contract

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”

“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”
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

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

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
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

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

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
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

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

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 Chicakdee”
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

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

But There Are Advantages to Using a Studio

- Non-Recourse, Low Rate Financing

- One Stop Shopping

- Better Contract Terms With Talent
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

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

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
- Information Signalling
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

Effect of Contract Form on Budget

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
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

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

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
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