1997

The Net Profits Puzzle

Victor P. Goldberg
Columbia Law School, vpg@law.columbia.edu

ESSAY

THE NET PROFITS PUZZLE

*Victor P. Goldberg**

The use of "net profits" clauses in the movie business poses a problem. The standard perception is that Hollywood accounting results in successful films showing no net profits. If that is indeed so, then why have they survived for over four decades? This Essay argues that a successful movie will fail to yield net profits only if a "gross participant" (a major star whose compensation is in part a function of the film's gross receipts) becomes associated with the film. Since the net profits participants typically are associated with a project first, the question becomes: Why would they be willing to sacrifice some (or all) of their contingent compensation when a gross participant is added to the project? The answer is that the net participants are made better off, ex ante, both directly by increasing their expected earnings, and indirectly because the studio is willing to pay for the increased flexibility. Contingent compensation is endemic in the movie industry. Because the inputs for the commercial success of a movie are not all supplied simultaneously, the compensation schemes will be tailored to induce effort at the appropriate time. If the studio-distributor gives up too much of the back-end, it waters down its incentives to market the film effectively. At the same time, giving the net profits participants a share of the back-end sharpens their incentives, both before and after the completion of production. The net profits clause nicely balances these two effects.

> Molly, I've never understood how I can have ten percent of the profit of a picture that grosses one hundred million dollars and costs only fifteen million to make, and then never see a penny. That's one mystery I'd like to solve before I die.[1]
>
> —Mario Puzo

It is not uncommon for Hollywood talent—producers, writers, and actors—to have part of their compensation based on "net profits." Since

---

* Thomas Macioce Professor of Law and Co-director of the Center for Law and Economic Studies, Columbia University. B.A. Oberlin College, 1963; Ph.D. Yale University, 1970. Earlier versions of this Essay have been presented at Columbia Law School and to a meeting of Columbia alumni. I thank the participants at those events for comments and suggestions. The Essay has also benefited from comments on earlier drafts from Phil Hacker, Henry Hansmann, Ben Klein, Ken Kleinberg, Michael Knoll, Dan Raff, Mel Sattler, Bobby Schwartz, Linda Silberman, and Mark Weinstein. I offer special thanks to Ron Gilson for his extremely helpful input at every stage of this Essay's development. Finally, I would like to thank William Chernenkoff for his research assistance.

1. Mario Puzo, The Last Don 318 (1996).

Art Buchwald's well publicized lawsuit against Paramount[2] concerning the lack of net profits for *Coming to America*, the common perception has been that "net profits" are illusory; Hollywood accounting will assure that films will fail to show a profit and net profits participants will go away empty handed. That perception is bolstered by the failure of other apparent successes, such as *JFK* and *Batman*, to show positive net profits. While data are difficult to come by, industry insiders suggest that of the approximately 130 major studio movies made each year,[3] fewer than twenty will pay off for the net profits participants.[4] The low likelihood of a payoff raises an obvious question: Why bother? Why not simply pay a fixed fee and eliminate the ephemeral contingent compensation? And why, despite recent legal attacks on net profits clauses, have the studios continued to include them in contracts? The persistence of the net profits deal and the studios' vehemence in defending it as an essential element in the way that Hollywood does business suggest that there might be some method to the apparent madness.

One line of explanation has been presented in litigation on behalf of disgruntled net profits (non)recipients. The compensation arrangements are said to reflect the power of the studios that impose their will upon the talent; the talent is powerless to vary the unconscionable terms presented them. This argument was accepted by one trial court in *Buchwald v. Paramount Pictures Corp.*[5] but rejected by another in *Batfilm Productions, Inc. v. Warner Bros.*[6] Although some commentators have found this argument persuasive,[7] the unconscionability analysis fails to explain why, if studios have the power ascribed to them, they would choose to exercise it in such a peculiar way.

---

2. See Buchwald v. Paramount Pictures Corp. (*Buchwald I*), 13 U.S.P.Q.2d (BNA) 1497 (Cal. Super. Ct. 1990). The story of the litigation is detailed in a book co-authored by Buchwald's lawyer, Pierce O'Donnell. See Pierce O'Donnell & Dennis McDougal, Fatal Subtraction (1992).

3. Between 1989 and 1994, about 1400 movies were released. The seven major studios released 640 of them, accounting for about 85% of domestic box office receipts. The mini-major studios produced 250 more, accounting for an additional 10% of domestic box office receipts. See Christopher Reynolds, 1995 Hollywood Power Stats 97 (1995).

4. These figures are based on conversations with industry people. Guesstimates of the number of films yielding net profits range from less than 5% to 20%, although most industry people I spoke with thought the latter too high. See Reed Abelson, The Shell Game of Hollywood 'Net Profits': Dreamworks May Be Shaking Up Some Time-Honored Accounting Habits, N.Y. Times, Mar. 4, 1996, at D1.

5. 13 U.S.P.Q.2d (BNA) at 1506-07 (addressing net profits for film *Coming to America*).

6. Nos. BC 051653 & BC 051654 (Cal. Super. Ct. Mar. 14, 1994) (addressing net profits for film *Batman*).

7. See David Edward Agnew, Profits of Doom: Net Profit Participation Contracts in the Motion Picture Industry, 15 Colum.-VLA J.L. & Arts 367, 406-07 (1991). "A group of 49 television and film writers, including Neil Simon, Gore Vidal and Larry Gelbart, placed an advertisement in *Variety* magazine to 'support Art Buchwald and Alain Bernheim in their lawsuit against Paramount Pictures and congratulate them on the recent landmark decision in their favor.'" Id. at 368 n.8 (citation omitted).

Part of the explanation is that the fate of net profits participants is not as bleak as the public perceives it to be. The conventional wisdom in Hollywood is that if a film without major stars succeeds, the net profits participants are likely to receive some contingent compensation. If, however, the film has "gross participants" (major stars whose compensation is in part a function of the film's gross receipts[8]), the net participants' recovery is far less likely. In many instances, the gross participants are added to a project after the net participants have already entered into their contracts with the studio. Solving the net profits puzzle thus requires an explanation of three things: (1) why net profits participants would agree to give up their contingent compensation if gross participants are subsequently added to the project; (2) why studios want to maintain the option of adding gross participants to the project; and (3) what function the expectation of net profits serves, and why that function is less important when there are gross participants in the project.

Timing in the movie business, as elsewhere, is (almost) everything. Movies are assembled sequentially. Some people sign on early before the project has taken shape, while others come in much later. Some, like screenwriters, perform most of their task at the outset. Others, notably the distributor, make the bulk of their contribution after production is nearly complete. The net profits participants (for example, the producer) usually sign on before they know either the other participants or the precise nature of the project. Having agreed to receive part of their compensation in the form of net profits, they are concerned with protecting their contingent claim from dilution, much as an investor in a corporation's debt or equity would be concerned about subsequent changes in the firm's capital structure. However, net profits participants, like their less artistic counterparts, do not want absolute protection; they would agree, ex ante, to dilute their claims under certain circumstances if that dilution were to increase their expected earnings. I will argue that by sacrificing some of their back-end compensation when gross participants are added to a project net participants can make themselves better off both directly, by increasing their expected earnings, and indirectly, because the studio is willing to pay for the resulting increased flexibility.

That accounts for only one blade of the scissors: Why would net profits participants be *willing to give up* most or all of their contingent earnings? The remaining question is *why would they want* a contract with net profits in the first place? Why make a portion of their compensation

8. A film's "gross receipts" comprise the total amount of revenue generated by the film. The sources of revenue include "(1) theatrical revenue or 'film rental'; (2) nontheatrical (armed forces and Red Cross; airlines; ships; oil rigs; and college campuses); (3) pay television . . . ; (4) network television; (5) television syndication; (6) home video; and (7) ancillary rights (music publishing; sound track recordings; merchandising; interactive/computer game rights; and novelizations)." David Nochimson & Leon Brachman, Contingent Compensation for Theatrical Motion Pictures 2 (1996) (on file with the Columbia Law Review).

contingent upon the film's commercial success, particularly on the contractually defined net profits? Timing, again, is a critical factor. Because the contributors to a movie's commercial success do not make all their contributions simultaneously, the compensation scheme will be tailored to induce effort at the appropriate time. The studio must make substantial distribution expenditures after most of the net profits participants have performed, and the smaller its share of the revenue stream, the weaker are its incentives to promote the film. Still, the studio would like to set aside some of the upside to influence the post-completion promotional behavior of the talent and to better contain some of the pre-completion costs as well.

The argument proceeds as follows: Part I sets the stage by giving some background information on contingent compensation in the movie business. Part II critically evaluates the unconscionability attack on net profits clauses. Part III then suggests that net profits participants are made better off ex ante by providing studios the flexibility to add gross participants to a project. Part IV discusses the incentive features of net profits clauses. In the concluding Part, I discuss briefly why the likelihood that a studio film will produce net profits has declined in recent years.

I. Net and Gross Participations

The "net profit" is a defined contractual term which differs substantially from generally accepted definitions of profit. A film could, therefore, be profitable for the studio even though the calculated net profits turn out to be a large negative number. The misleading terminology is responsible for some of the confusion regarding net profits participations.[9]

Although there were some net profits contracts in the heyday of the studio system (pre-1948), Jimmy Stewart's contract for *Winchester '73* in 1950 is generally viewed as the first modern net profits agreement. With Universal Studios financially strapped, Stewart agreed that instead of receiving his usual fee of $250,000 he would defer his compensation and receive 50% of the net profits, defined in the contract as the film's gross revenues less twice the "negative costs" (the cost of producing the film, as

9. David Nochimson and Leon Brachman note:

> The subject of contingent compensation in the theatrical motion picture business is most customarily associated with the phrase *net profits* and this is where the trouble usually begins. Net profits conjures up in the minds of profit participants an accounting concept, and when these expectations are not realized, the [studio] is accused of chicanery and sometimes worse. What must be kept in mind . . . is that net profits participation[s] . . . are negotiated contractual definitions which have evolved within the motion picture industry and have little to do with real profit of a picture as measured by generally accepted accounting [principles].

Id. at 1.

distinguished from distribution costs).[10] Stewart's contract differs from the now-standard net profits agreement in two respects. First, the standard agreement contains a fixed compensation component, payable regardless of the film's subsequent success.[11] Second, the standard net profits agreement determines "costs" in a quite different manner that results in the film achieving net profits (attaining breakeven) at higher revenue levels than under Jimmy Stewart's formula.[12]

To simplify somewhat, the basic net profits formula subtracts from the studio's (distributor's)[13] adjusted gross receipts[14] the production costs, distribution expenses, and distribution fees.[15] If that number is negative, it is disregarded. *Production costs* are all costs directly attributed to the particular film (plus overhead). For the major studios in 1995, such costs averaged over $36 million per film.[16] Production costs include the payments to all other participants in a film including the contingent

10. For a fuller description of Stewart's contract, see the Declaration of one of Paramount's expert witnesses, Mel Sattler, in Declarations of Defendant Paramount Pictures Corporation at 9–10, *Buchwald I* (No. C 706083).

11. Actually, the film need not even be made. The fixed component will usually be payable if the project is made "pay or play"; that is, the project has proceeded far enough along so that the studio commits to paying the fixed fees of a number of key personnel, and they agree to be available for a specified time period. See 2 Eric B. Yeldell, The Motion Picture and Television Business: Contracts and Practices § 18.06, at 18-54 (1987).

12. See 2 id. § 18.01, at 18-6 to 18-7.

13. In this essay I will use "studio" and "distributor" interchangeably.

14. Two points must be made. First, "adjusted gross" subtracts from the film's gross receipts such "off the top" items as taxes, currency conversion, guild residuals and royalties, trade dues, and so forth. See 2 Yeldell, supra note 11, § 18.03, at 18-43. It does not include any revenues from theater concessions since all those revenues go to the theaters, not the studios. It also includes only 20% of the studio's revenues from video cassettes. Thus, while Paramount's video cassette revenues for *Coming to America* were $45 million, only $9 million went to the picture's account. See O'Donnell & McDougal, supra note 2, at 360. Second, the gross receipts in question are those of the *distributor* (the studio), not the box office receipts that are often reported in the press. Approximately half the domestic box office receipts go to the exhibitors (theaters) and half to the distributors. See Reynolds, supra note 3, at 4. This can lead to some confusion in discussing the commercial success of particular movies. For example, discussions of the fate of the net profits participants in *Coming to America*, *Batman*, and *Forrest Gump* often cite box office gross receipts to heighten the absurdity of a movie making so much money, yet still not achieving net profits. Revenues from other sources, notably videocassettes, are sometimes included in the inflated revenue statements as well. News reports of the dispute over *Gump*'s failure to produce net profits routinely referred to its receipts of over $660 million while the studio revenue amounted to less than $200 million. See Adam Sandler, New Recipes Cooking for Net Profit Pie, Variety, June 5, 1995, at 7, 15. So, too, did the Complaint in *Garrison v. Warner Bros.* See First Amended Complaint, Garrison v. Warner Bros., Inc., No. CV 95-8328 (C.D. Cal. filed Nov. 17, 1995). See also Bernard Weinraub, 'Gump,' a Huge Hit, Still Isn't Raking In Huge Profits? Hmm., N.Y. Times, May 25, 1995, at C15.

15. Other items, notably interest, are also usually deducted; the significant items, however, are covered by these three categories. See 2 Yeldell, supra note 11, § 18.06, at 18-6.

16. See David H. Horowitz & Peter J. Davey, Financing American Films at Home and Abroad, 20 Colum.-VLA J.L. & Arts 461, 463 (1996).

compensation of gross participants.[17] So, for example, since Eddie Murphy had fifteen gross points for *Coming to America* (that is, he received 15% of the gross receipts), every dollar of revenue that the film generated pushed the net profits breakeven point back fifteen cents.[18] Thus, if a film has significant gross participants, the breakeven point quickly recedes. Almost all the box office smashes that failed to produce net profits had significant gross participants.[19]

Distribution expenses, principally production of prints and advertising, averaged about $17 million per film in 1995.[20] Distribution expenses are identifiable costs attributable to the particular film (again, plus overhead). *Distribution fees* are not related directly to specific costs. Rather, they are assessed as a percentage of receipts, with the percentage varying with the source. So, distribution fees for a particular film might be 30% for domestic box office, 40% for foreign box office, 25% for domestic network television, and so forth.[21] As with gross points, an increase in revenue increases the amount due the studio under the distribution fee and shifts out the breakeven point.

The distinction between net and gross participations is not as significant as might first appear. In both instances, the participant receives a fixed fee and contingent compensation that comes into play after a breakeven point. It is the nature of the breakeven point that distingnishes net and gross participations. The net participants have a rolling breakeven that depends upon costs, receipts, and the distribution fee. The so-called "first-dollar" gross participation is set off against the talent's fixed fee (which would amount to a non-refundable advance against earnings).[22] The first-dollar gross participant has a fixed breakeven point—the advance (the fixed fee) divided by the sharing rate—that de-

---

17. Typically, net profits participants will all share from the same pool; the contingent earnings of one will not decrease the size of the pool for the others. The contract could require, however, that the net profits paid to others be treated as a production expense as well. For an example, see 2 Yeldell, supra note 11, § 18.01, at 18-7.

18. Actually, it recedes even further since the studio will assess a 15% overhead charge on the additional cost and will also charge interest on it. See id. § 18.05(G), at 18-52.

19. *Indecent Proposal*, which was over $35 million in the red despite its being a commercial success, had five gross participants: stars Robert Redford, Demi Moore, and Woody Harrelson; producer Sherry Lansing; and director Adrian Lyne. See Robert W. Welkos, Another Flap over a Movie's Net Profits, L.A. Times, Sept. 12, 1995, at F1. Other successes that failed to show net profits include *Fatal Attraction*, *War Games*, and *Rain Man*. See O'Donnell & McDougal, supra note 2, at 383; Agnew, supra note 7, at 397; Abelson, supra note 4, at D1.

20. See Horowitz & Davey, supra note 16, at 463–64. Advertising accounted for about 75% of distribution costs in the mid-1980s. See 2 Yeldell, supra note 11, § 18.02, at 18-29.

21. See 2 id. at 18-16.

22. In some instances the talent might forego an advance and simply take a share of the adjusted gross receipts. According to press accounts, Robert Redford took no upfront fee for *Indecent Proposal*, taking between 10% and 15% of the gross. He is said to have earned $20–$25 million. See Welkos, supra note 19, at F5. Tom Hanks and Robert Zemeckis purportedly had a very small front-end compensation on *Forrest Gump* and a large enough share of the back-end to yield them over $60 million. See Nick Roddick, The

pends on receipts only. So, for example, for *Coming to America* Eddie Murphy would have received no contingent compensation until the film's gross revenue exceeded his advance ($8 million) divided by his 15% share, or $53 million.[23] The first-dollar deals go to the superstars, who in 1996 were commanding over $10 million, or in some instances $20 million, in advances.[24]

Other variations that go under the gross participation rubric are, essentially, net profits deals with a lower breakeven.[25] As in the standard net profits arrangement, the contingent compensation is in addition to the fixed fee. The director of *Coming to America*, John Landis, for example, received 10% of gross above a negotiated breakeven point determined by subtracting a 20% distribution fee and only certain production costs from the gross receipts.[26] These deals could also subtract certain distribution costs from the gross; or they could, like Jimmy Stewart's deal, define breakeven as a multiple of production costs. In most such arrangements, after breakeven is reached, no further distribution fees are charged against the participant.[27] Participants in these modified gross deals will reach breakeven sooner than the net profits participants. Their contingent compensation will be included in the production costs in the net profit definition, so these payments too will shift out the breakeven point for the net participants.[28]

Bigger They Come . . ., The Observer, July 2, 1995, available in LEXIS, Nexis Library, CURNWS File.

23. See O'Donnell & McDougal, supra note 2, at 353.

24. In 1996, actors with a fixed fee per film of $20 million included John Travolta, Mel Gibson, Jim Carey, Harrison Ford, Sylvester Stallone, Tom Cruise, and Arnold Schwarzenegger. See Matthew Gilbert, Box Office Star Power: In Summer's Films, Big Names Don't Always Deliver, Boston Globe, Aug. 25, 1996, at N1.

25. See 2 Yeldell, supra note 11, § 18.03, at 18-44.

26. See O'Donnell & McDougal, supra note 2, at 296–97; Declarations of Defendant Paramount Pictures Corporation, Declaration of David J. Leedy at 55, Buchwald v. Paramount Pictures Corp. (*Buchwald I*), 13 U.S.P.Q.2d (BNA) 1497 (Cal. Super. Ct. 1990) (No. C 706083).

27. "The 'adjusted gross after a rolling breakeven' . . . is basically the equivalent of a typical net profit participation except that distribution fees are charged only on that amount of the gross receipts needed to reach breakeven." 2 Yeldell, supra note 11, § 18.03, at 18-44. One commentator distinguishes the adjusted gross after a rolling breakeven from the net participation:

> No matter when a gross participant becomes entitled to participate—be it from "first dollar," or after a defined breakeven occurring at the same or a different time than breakeven for a net profit participant, or after breakeven defined as a multiple of negative cost, or at an arbitrary amount of gross receipts—at some point he will share in receipts with the studio, without deduction of a distribution fee from his share. In contrast, a net participant always has a distribution fee deducted from every dollar of receipts in which he participates.

Declarations of Defendant Paramount Pictures Corporation, Declaration of David J. Leedy at 54–55, *Buchwald I* (No. C 706083).

28. For further details on net and gross participations, see Nochimson & Brachman, supra note 8, at 1–15. See generally 2 Yeldell, supra note 11, § 18 *passim* (discussing details of net and gross participations).

The accounts of *Coming to America* illustrate how a successful picture can fail to produce net profits.[29] By the end of 1989, Paramount had received $125 million. Negative costs, excluding gross participations, were $47 million, distribution costs $36 million, and distribution fees an additional $42 million.[30] Eddie Murphy's gross points had yielded about $10 million, and Landis's an additional $1 million. With interest of $6 million, the accounts showed the movie to be still about $18 million in the red. Of each additional dollar of revenue received, about one-third would go toward reducing that deficit. Even if Murphy and Landis had received only their fixed fees, there still would have been no net profits.

Forrest Gump provides another example, although it might eventually show a modest net profit. By the end of 1994 Paramount had received about $191 million.[31] Distribution costs were about $73 million. Distribution fees (32% of the gross) were about $62 million. Negative costs, before taking into account gross participations by Tom Hanks and director Robert Zemeckis, were about $66 million. The gross participants each were entitled to 8% of the gross and had received about $20 million each (with Paramount reckoning 15% overhead on that as an additional negative cost). After including an additional $6 million for interest, the picture remained over $60 million short of the breakeven point.[32]

The studios undoubtedly set themselves up for ridicule by misnaming the back-end compensation as a share of "net profits."[33] Some ele-

29. See Plaintiffs' Preliminary Statement of Contentions Concerning Accounting and Damages Issues at 8–16, *Buchwald I* (No. C 0706083). I have done some rounding, so the numbers do not quite add up.

30. The production and distribution costs both included contractually determined overhead assessments of 15% and 10%, respectively. See id. at 73.

31. See Nina Munk, Now You See It, Now You Don't, Forbes, June 5, 1995, at 42 (discussing accounting methods used to determine *Forrest Gump*'s profitability). In the next six months it took in over $100 million more not counting revenues from the videocassette, soundtrack, and licensing fees on such products as Forrest Gump wristwatches and cookbooks. Some of these ancillary revenues would be included in *Gump*'s revenues for determining the film's net profits. See Sandler, supra note 14, at 7.

32. See Munk, supra note 31, at 42–43. Despite claims of author Winston Groom's lawyer, Pierce O'Donnell, that the film would remain forever in the red, the net profits participants (author Winston Groom, screenwriter Eric Roth, and producers Wendy Finerman and Steve Tisch) did receive some contingent compensation from the movie. At the time the $62 million "loss" was disclosed, Paramount announced that it had paid a $3 million "advance against profits" to the net profits participants. See Weinraub, supra note 14, at C15. Still, as late as March 1996, news reports asserted that the film had yet to show a profit. See Abelson, supra note 4, at D6.

33. The Complaint in *Garrison v. Warner Bros.* suggests that the studios are attempting to change their terminology:

> In recent months, studio legal departments have reacted to court decisions on Talent contracts by attempting to place a new face on the old, discredited system. Studio lawyers have been replacing the term "net profit" with some euphemisms like "net proceeds" or other terms designed to hide the fact that the unconscionable practice continues.

First Amended Complaint at 25–26, Garrison v. Warner Bros., Inc., No. CV 95-8328 (C.D. Cal. filed Nov. 17, 1995).

ments of the compensation scheme are directly related to costs, but others, notably the distribution fee and various overhead charges, are not. The formula will fail to show net profits until long after a movie is profitable in more familiar terms. If the film has significant gross participants, it is likely that even if the film is a box office success, it will fail to record net profits. Note that it is not the gross formula per se that prevents the net participants from receiving back-end compensation. If Eddie Murphy's contract called for an $18 million flat fee and no gross points, Art Buchwald would have fared just as poorly. Buchwald loses because of the *size* of the claims of those ahead of him in the queue, not the *shape* of those claims. Since the size and shape are correlated (big earners get gross points), for our purposes the distinction does not much matter.

The breakeven point depends on the presence of gross participants and on the magnitude of the production and distribution budgets. These are interrelated. Big stars are not substitutes for production and distribution expenses; they are complements. If a studio adds a gross participant to a film, other things being equal, the negative costs (net of that star's compensation) and distribution costs increase. Bigger stars appear in films with bigger production budgets. And films with bigger production budgets will have bigger distribution budgets as well. Consequently, adding a gross participant to a film has a magnified effect on the rate at which the breakeven point recedes. Still, on occasion net profits participants do win. Some films—for example, *Flashdance, Airplane* and *Grease*—have paid off handsomely.[34] The writer of the screenplay for *An Officer and a Gentleman* reportedly earned $5 million from a 5% net profits interest.[35] In *Buchwald,* Paramount introduced evidence showing that in the previous fifteen years it had paid out over $150 million to eighty-nine net profits participants in twenty-nine movies.[36]

II. UNCONSCIONABILITY

Haggling over net profits clauses has long been a Hollywood sport, and the disputes often end up in litigation. But only recently has the basic contract come under attack. In this Part, I will describe briefly the litigation regarding three films—*Coming to America, Batman,* and *JFK*—in which disappointed net profits participants attacked the validity of the standard studio agreements.

The *Coming to America* story has been told in an entertaining book coauthored by the plaintiffs' attorney, Pierce O'Donnell.[37] Producer Alain Bernheim entered into an agreement with Paramount Studios giving the

34. See O'Donnell & McDougal, supra note 2, at 410.

35. See Agnew, supra note 7, at 383 n.97. There were no gross participants in that film. See id.

36. See Buchwald v. Paramount Pictures, Corp. (*Buchwald II*), No. C 706083, at 20 (Cal. Super. Ct. Dec. 21, 1990) (claiming Paramount paid out $150 million).

37. See O'Donnell & McDougal, supra note 2.

studio the option to develop a treatment by humorist Art Buchwald originally entitled *It's a Crude, Crude World*, subsequently rechristened *King for a Day*. The movie, if made, would have been produced by Bernheim. Paramount abandoned the project, but then produced *Coming to America*, which Bernheim and Buchwald claimed was based on Buchwald's original treatment. In a hotly disputed and well publicized trial, the court held that *Coming to America* was indeed based on Buchwald's treatment and that Paramount had breached its contract.[38] If damages had been assessed as per contract, the plaintiffs would have won their fixed fee, a combined $265,000, plus their share of the net profits. That share, however, would have been worthless since the movie never earned net profits by Paramount's accounts. In the trial's second phase, the plaintiffs succeeded in having the compensation formula based on net profits declared unconscionable. In a third phase, the court rewrote the contract, determining that Bernheim was due $750,000 and Buchwald $150,000. While the case was on appeal, the parties settled, reportedly for $825,000. Total litigation costs have been estimated at $12 million.[39]

Both plaintiffs had been represented by agents; Bernheim's was Roger Davis, Executive Vice President of the William Morris Agency, a significant figure in the industry. Bernheim received $10,000 as a development fee and would have received an additional $150,000 if the film had been produced; this latter fee would have increased to $200,000 if he had produced another movie after entering into this contract but before commencement of principal photography. In addition, he would have received 35% of net profits (which would have increased to 40% if he had produced another movie). However, his net profits share could have been reduced to 17.5% if other net or gross participants had been added to the project. This reduction of the net profit rate was set out in a standard term in a producer's contract, the so-called "consultation clause."[40] Paramount agreed to consult with him about adding gross and net participants to the film if doing so would reduce his share, but Paramount's decisions on such matters would be final. Paramount paid Buchwald $10,000 for a standard one-year option. If the option were exercised, Paramount would pay $50,000; it would pay an additional $15,000 upon commencement of principal photography and 1.5% of the net profits.[41]

38. See Robert W. Welkos, Buchwald, Paramount Settle Film Dispute, L.A. Times, Sept. 13, 1995, at D2.

39. See id. at D11.

40. See Plaintiffs' Preliminary Statement of Contentions Concerning Accounting and Damages Issues at 75–76, Buchwald v. Paramount Pictures Corp. (*Buchwald I*), 13 U.S.P.Q.2d (BNA) 1497 (Cal. Super. Ct. 1990) (No. C 706083); see also Declaration of Helene Hahn at 110–11, *Buchwald I* (No. C 706083) (discussing terms of Bernheim's contract).

41. For a summary of the Bernheim and Buchwald contracts, see Plaintiffs' Preliminary Statement of Contentions Concerning Accounting and Damages Issues at 73–77, *Buchwald I* (No. C 706083).

Judge Schneider held that the contract—or at least seven clauses of the standard net profits agreement—was unconscionable.[42] He did not claim that Buchwald and Bernheim had been snookered in any way. They were, after all, represented by sophisticated agents. However, Bernheim, said Schneider, lacked "clout."[43] Because of the "inequality of bargaining power" between Paramount and Bernheim, the contract terms were substantially dictated by the studio.[44] Calling the contracts oppressive and one-sided, Judge Schneider held that if the contracts reallocated risk in an unreasonable way they could be deemed unconscionable. He concluded that seven specific cost items relating to overhead and interest were not justified by Paramount and were therefore unconscionable.[45]

The court's reasoning was fuzzy at best. It was apparently driven by the belief that Paramount had to justify the various pieces of its cost formula. Paramount had argued that it needed to recoup more than its costs on its few big successes because winners had to subsidize losers. Paramount invoked this argument, dubbed the "risky business" defense, to explain why the breakeven for net profits participants came so late, but ultimately dropped the argument, apparently to avoid disclosure of confidential information regarding the profitability of its films.[46] Paramount's silence left an explanatory vacuum. That vacuum was decisive for Judge Schneider:

> So long as Paramount maintained its net profit formula was justified by the nature of the motion picture industry, the court felt an inquiry into Paramount's profitability was necessary and proper. In effect, Paramount was arguing that the net profit formula was justified in order to properly allocate the risks between Paramount and Bernheim, Paramount's position being that it bore substantially all of the risks. The court reasoned that if Paramount's representations as to its profitability were untrue, i.e., if it really ran no meaningful risk because of the profit structure of its business, then its argument that the net profit formula was justified would fall by its own force.[47]

Buchwald's lawyers and some sympathetic commentators argued that moviemaking (at least by the major studios) was not so risky because many, perhaps most, films made money.[48] The high distribution fee and other features of the net profits deal were not necessary for the winners

42. See Buchwald v. Paramount Pictures, Corp. (*Buchwald II*), No. C 706083, at 24–26 (second phase decision).

43. Id. at 4.

44. Id. at 11.

45. See id. at 24–26.

46. See O'Donnell & McDougal, supra note 2, at 435–36, 440–42, 450–52, 460.

47. *Buchwald II*, at 16 n.4.

48. See O'Donnell & McDougal, supra note 2, at 415, 432–33; see also Agnew, supra note 7, at 399–403 (asserting that "the uncertainty studios face is often small relative to the potential profits which might be earned").

to compensate for the losers, since there were few losers. But this misses the point. Regardless of what fraction of films made money (by some accounting definition), it is surely correct that there is a large variance in the earnings of films. If money is to be invested in the film industry, where some films do relatively poorly and many projects do not make it to the screen at all, firms have to expect to take in enough revenue on their successes (and their limping successes and their failures) to justify making the investment.[49] But this is true regardless of whether the studio shares revenue with the talent. Thus, while Paramount's basic point was undoubtedly correct—making movies is indeed a risky business—its truth has no bearing on the questions of whether the studio should share revenue with the creative talent and how it should do so.

Paramount might have to justify its investment decisions to its shareholders, but why must it justify particular contract terms to anyone? Surely, the creative talent has no natural right to a piece of a successful movie. The right is determined by contract and there is no reason that contractually defined terms need conform to some court-proposed definition of costs or profits (as in the seven terms identified by the court). The court implicitly adopted the position that (a) people with a lot of clout (Eddie Murphy) can bargain for gross points and are therefore not victims of unequal bargaining power; (b) people with some clout (Alain Bernheim), who get net points but cannot bargain over the terms, are victims of unconscionable contracts entitled to have them rewritten by the courts; and (c) people further down the food chain with no clout, who receive no net points, cannot complain about their compensation because none of the unconscionable clauses are included in their contracts. Making the decision even more peculiar, the court failed to find the distribution fee itself unconscionable. Deleting the cost elements identified by the court and increasing the distribution fee by a few percent would yield essentially the same outcome.

Two years after the *Buchwald* decision, and one year before the case settled, another California court held that the net profits clause in the contract of the producers of *Batman* was not unconscionable.[50] In 1979, Benjamin Melniker and Michael Uslan obtained an option on the motion

49. The movie business is hardly unique in this respect. Oil drilling is an obvious analogy, with the occasional gusher covering the costs of exploration and the numerous dry holes. Also, in venture capital funds, most of the profits come from 20% of the investments. See discussion of the 2:6:2 rule in William D. Bygrave & Jeffry A. Timmons, Venture Capital at the Crossroads 168–69 (1992). The 2:6:2 rule is "a rule of thumb for a successful venture-capital portfolio" and represents the optimal ratio of "big winners . . . to other winners–mediocrities–partial losers to total losers." Id. at 168. Retail sale of clothing provides a more mundane example, with the good sales in some lines in a particular season carrying the poor sales in others.

50. See Batfilm Productions, Inc. v. Warner Bros. Inc., Nos. BC 051653 & BC 051654 (Cal. Super. Ct. Mar. 14, 1994). For some background on the *Batman* case, see Nancy Griffin & Kim Masters, Hit & Run: How Jon Peters and Peter Guber Took Sony for a Ride in Hollywood 164–74 (1996).

picture rights to Batman comic book characters. They made a development and production deal with Casablanca Productions which was amended nine years later so that the film could be made with Warner Bros. Their fixed compensation as executive producers for *Batman* was $300,000. In addition, they received a $100,000 deferment, payable after the film generated a certain level of receipts, plus 13% of the net profits.[51] Although one of the biggest box office successes in history, the picture remained $20 million in the red.[52] Represented by Pierce O'Donnell, the same lawyer who represented Art Buchwald, they sued Warner for $8 million.

In finding for Warner, the court made clear that the plaintiffs were not naive beginners, but rather were wise to the ways of Hollywood.[53] It rejected the claim that the unfairness of the contract made it unconscionable:

> At the core of plaintiffs' case is their argument that the contract was not fair to them because Warner Bros. and others earned millions of dollars on *Batman* and plaintiffs did not. The answer to that argument is that ever since the King's Bench decided *Slade's Case* in 1602, right down to today, courts do not refuse to enforce contracts or remake contracts for the parties because the court or the jury thinks that the contract is not fair.
>
> That principle is not some medieval anachronism. This society, this country, this culture operates on the basis of billions of bargains struck willingly every day by people all across the country in all walks of life. And if any one of those people could have their bargain reexamined after the fact on the ground that it was not fair or on an assertion that it was not fair, we would have a far different type of society than we have now; we would have one that none of the parties to this case would like very much.[54]

Despite the rhetoric, the court did consider the plaintiffs' complaints about specific charges (mainly overhead and interest), but ultimately rejected them for the following reason:

---

51. See *Batfilm Productions, Inc.*, at 2–3.

52. *Batman*'s domestic box office gross exceeded $250 million, of which about 60% went to Warner Bros. See Reynolds, supra note 3, at 1. Jack Nicholson had a contract giving him an increasing share of the gross; he reportedly earned over $50 million for his portrayal of the Joker. See Agnew, supra note 7, at 396 n.181.

53. As the court in *Batfilm Productions, Inc.* noted:

> Mr. Melniker negotiated the Warner Agreement on his and Mr. Uslan's behalf. No one is less likely to have been coerced against his will into signing a contract like the Warner Agreement than Mr. Melniker. This former general counsel and senior executive of a major motion picture studio (Metro-Goldwyn-Mayer) knew all the tricks of the trade; he knew inside and out how these contracts work, what they mean, and how they are negotiated.

Batfilm Productions, Inc., at 4.

54. Id. at 4–5.

> [T]he plaintiffs failed to prove that historically Warner Bros.' indirect general administrative expenses for motion picture production and advertising—"overhead"—do not equal or exceed the amount charged under the "Net Profits" definition, namely, 15 percent of production costs and 10 percent of advertising expenditures. As a matter of fact, plaintiffs conceded that they could not show that the overhead charges under the "Net Profits" definition exceeded Warner Bros.' actual overhead costs, taken as a whole.[55]

If the contract had defined production cost overhead as 15% when in fact it was 2%, why should this matter, so long as the complaint was not that Warner Bros. defrauded the producers with a devious definition or overly aggressive accounting? That is, so long as Hollywood professionals know that charges labeled "overhead" in a net profits agreement need bear no relationship to any costs actually incurred by the studio, proof that the overhead charge is not grounded in reality should gain the plaintiff nothing.[56]

The most recent case involving a suit over net profits was filed in November 1995 by the estate and heirs of Jim Garrison, which have yet to receive net profit payments from *JFK* despite the film's gross of over $150 million.[57] The suit ups the ante since it is a class action against seven major studios and the Motion Pictures Association of America and because it includes antitrust causes of action (price fixing and concerted refusal to deal). The plaintiff class includes more than 2000 authors, screenwriters, actors, producers, and directors who have entered into standard net profits contracts.[58] The complaint includes the familiar litany of unreasonable overhead and interest charges. Labeling net profits "a scam that has endured nearly a half century"[59] the complaint asserts that the studios work in concert "to fix, lower, maintain or stabilize the prices they paid to Talent."[60]

It is hard to imagine how a conspiracy fixing the back-end compensation of some of the talent could possibly benefit the studios. The back-end compensation is only a small piece of the reward; indeed, as the Garrison family learned, it can be a vanishingly small part of the compensation package. What purpose could be served by conspiring to fix the

55. Id. at 7.

56. It seems odd to suggest that a gross mismatch between contract overhead and "actual overhead" would make a contract unconscionable, especially if the studio could rename the overhead as "a gratuitous fee that we assess just because we want to." Because I am attempting to explain net profits compensation, not explore unconscionability, I will not pursue this point further.

57. See Garrison v. Warner Bros., No. BC 139282 (Cal. Super. Ct. filed Nov. 17, 1995). The movie was based on Garrison's book. See Jim Garrison, On the Trail of the Assassins (1988).

58. See Roger Parloff, Son of Buchwald, Am. Law., Oct. 1996, at 58, 60–61.

59. First Amended Complaint at 2, Garrison v. Warner Bros., Inc., No. CV 95-8328 (C.D. Cal. filed Nov. 17, 1995).

60. Id. at 11.

tail while the dog remains freely negotiated? Why agree on a rather convoluted contingent compensation clause when it would surely be simpler to agree to give no back-end compensation at all?

While I obviously do not think the unconscionability or antitrust complaints have legal merit, that is beside the point. Neither "theory" helps answer the central questions: Why make any of the compensation of this class of talent contingent on the commercial success of the film? And why does the class's breakeven point depend so much on the presence of superior (more marketable) talent—the gross participants? Neither "studio power" nor "conspiracy" is a sufficient answer to these questions. The expected value of the talent's compensation package will depend upon the studio's evaluation of the individual's ability to sell tickets, and the relevant alternatives. That market value is the talent's "power." Eddie Murphy could command $8 million in straight salary; Alain Bernheim could not. Eddie Murphy could balk at the studio's standardized terms; Alain Bernheim could not. Eddie Murphy could demand first dollar back-end compensation; Alain Bernheim could not. The price of the talent is correlated with the quality of its contingent compensation: high priced talent takes gross, lower priced talent takes net, and still lower priced takes naught. Treating the marketability of the talent as a manifestation of unconscionability simply obscures the real question: Why do we observe this *form* of payment?

III. Why Give Up Net Points?

Assume for the moment that making a portion of the talent's compensation contingent upon net profits serves a useful function, a point I will develop in the next Part. Here I ask why a net profits participant would be willing to sacrifice some or all of those net profits in certain circumstances. To simplify the discussion, I will focus on a particular net participant, a producer like Alain Bernheim.

Movies are put together sequentially with the producer typically signing on to the project before most of the other participants are even known. The producer's compensation typically will be in at least three pieces. The producer will receive a fairly modest development fee to begin the process of shepherding the basic concept to the screen.[61] Most movie projects never make it to the screen,[62] so it is quite likely that a producer will devote months of his time to a project and end up receiving

61. Bernheim's $10,000 was typical of its day. Based on conversations with industry insiders, I understand that development fees today are in the $25,000–$50,000 range.

62. Estimates of the number that reach production vary, with 15% probably being the outside limit. See Declarations of Defendant Paramount Pictures Corporation, Declaration of Sidney H. Sapsowitz at 72 n.5, Buchwald v. Paramount Pictures Corp. (*Buchwald I*), 13 U.S.P.Q. 21 (BNA) 1497 (Cal. Super. Ct. 1990) (No. C 706083); see also O'Donnell & McDougal, supra note 2, at 292, 294 (describing testimony of Bruce Berman and Neal Tannen, Hollywood studio executives, regarding the small number of film proposals which actually make it through the production process).

only the modest development fee. If the project advances far enough for the studio to make a serious commitment, the producer is made "pay or play." That is, the studio makes a commitment to pay the producer a further sum even if the project is not completed. The studio reserves the right to either abandon the project or to replace the producer, but if it does either it must pay the producer the second installment, usually called the fixed compensation, which will be a substantial amount.[63] If the producer remains with the film and it is produced, he receives the fixed component and he also becomes eligible for the third component, the back-end contingent compensation, which for most producers would come in the form of net profits.

If the movie is made with no-name talent and it succeeds at the box office, the back-end could be substantial. The producer has, in effect, a priority claim on a possible future stream of income from the project; he does not want the studio to enter into subsequent contracts that might water down his claim. In this sense, he is like an investor in a corporation's debt or equity who wants to prevent subsequent revisions of the firm's capital structure that would reduce the value of the claim. Like the investor, the producer recognizes that there will be some situations in which diluting his claim will still increase his expected future income. In particular, he might be willing to give up net points or move the breakeven point back (or both) if superior talent is brought into the project. Mel Sattler, an industry veteran and expert witness for Paramount in *Buchwald* put the point well:

> [P]roducers do not complain about the studio's decision to grant "Net Profits" participations even though they reduce the producer's share. . . . [T]he producer knows in advance that he will be trading his contractually allocated "net" points to obtain the services of a proven talent. That increases the likelihood that the motion picture will be produced (which triggers payment to the producer of his "up front" fixed compensation) and be successful.
>
> The situation is no different in the case of a so-called "Gross" participant. Obviously, a talent that commands a "Gross" deal has enjoyed even greater success than the talent that only receives a "Net" deal. The producer is even more delighted to have a major "star" involved in a project . . . .[64]

The consultation clause in which the producer agrees in advance to reduce his net points from around forty to around twenty if net or gross participants are subsequently added to the project is one manifestation of

63. See Plaintiffs' Preliminary Statement of Contentions Concerning Accounting and Damages Issues at 73–77, *Buchwald I* (No. C 706083). Recall that Bernheim's fixed compensation was $200,000. See supra text accompanying note 41.

64. Declarations of Defendant Paramount Pictures Corporation, Declaration of Mel Sattler at 36–37, *Buchwald I* (No. C 706083).

this ex ante agreement to reduce the producer's share.[65] A second is the outward shift of the breakeven point if high-priced talent (especially talent that could command gross points) is added to the project.

Adding high-priced talent does more than simply increase the likelihood that the movie will be made. There is also a greater likelihood that the movie will be a commercial success. While the success might not be sufficient to yield net profits given the higher breakeven point, it can still redound to the producer's financial benefit. If the movie is a success, the probability that the producer will be offered another project increases; so too, most likely, will his fixed compensation on the subsequent picture.[66] Bernheim's contract itself illustrated this link between actually making a picture (regardless of its commercial success) and the size of fees for subsequent movies. Both his fixed fee and his net profit share would have increased had he merely begun another picture before *Coming to America* was set for production. Winston Groom's experience following the success of *Forrest Gump* provides a vivid illustration of the financial possibilities stemming from a smash hit. His novel sold only 9000 copies when it first appeared about a decade before the film. After the movie it sold about 1.8 million copies in paperback and an additional 36,000 in hardcover. A second book of "Gumpisms" sold an additional 600,000 copies.[67]

Thus, adding a star worthy of gross points to a project will increase the producer's expected future earnings even though it means that he is

---

65. The plaintiffs' witnesses in *Buchwald* put a different spin on the consultation clause:

> Based on my experience negotiating hundreds of similar contracts, the consultation provision at issue here means, at a minimum, the obligation to consult in good faith, listen to the other side, and, to the extent the other side's position is reasonable, to accommodate it. The obvious purpose of such a consultation clause, in connection with the studio's subsequent giving away of gross and other participations, is to enable the initial net profit participant (like Bernheim) to protect the value of his participation (or its equivalent) by some alternative means if the studio does indeed contemplate taking steps that will substantially reduce or eliminate his participation.

Declaration of Rudolph Petersdorf at 17, *Buchwald I* (No. C 706083)

> Writers and producers are in an especially vulnerable position because they necessarily make their deals early in the motion picture development process and are therefore subject to having their participations reduced by subsequent participations. It is for this reason that a consultation provision obligating the studio to consult with the writer or producer regarding decisions that will affect their profit participation is so important.

Declaration of Roger Davis at 8, *Buchwald I* (No. C 706083).

66. For a discussion of the value of a track record in entertainment, see 1 Thomas D. Selz et al., Entertainment Law §§ 9.02–9.06 (2d ed. 1992). Successful movies are more likely to breed sequels, and, since the producer's contract typically gives the producer the option to participate in sequels, this provides additional compensation. Melniker and Uslan, for example, were given executive producer credit on four *Batman* sequels. See The Internet Movie Database Ltd (visited Jan. 17, 1997) <http://us.imdb.com>.

67. See Robert W. Welkos, 'Gump' a Smash but Still in the Red, Paramount Says, L.A. Times, May 24, 1995, at A1.

much less likely to see back-end compensation from the picture. It might seem counterintuitive that an agreement to forego one piece of compensation under certain conditions would redound to the producer's benefit, but this is just another variation on a common theme: by agreeing in advance to allow its interest to be diluted under specified conditions, a party can be better off than if it had insisted upon absolute protection.[68]

Even if he received no *direct* benefits from sacrificing the back-end compensation, the net profits participant could benefit indirectly. Because the studio values the option to add gross participants, the compensation paid to net profits talent already reflects a premium for that option. In other words, if the studio were denied the option to add gross participants, then the producer's fixed compensation would likely be less. The studio, the major claimant on the project's future revenue stream, wants the ability to adapt as new information and opportunities come along. On the downside, it maintains the option to abandon the project altogether. Exercising this option can be quite expensive if the project has gone far enough along so that the major players are "pay or play."[69] On rare occasions studios have killed a project after the entire film was shot.[70] The studio needs the flexibility to adapt as scripts are rewritten, particular talent becomes available, or the concept switches from, say, a made-for-TV movie to a big screen star vehicle. The "pay or play" clause, for example, preserves (at a hefty price) the studio's option to substitute talent better suited to the new circumstances.[71] Had Paramount made

---

68. For example, holders of subordinated debentures will sometimes allow subsequent suppliers of capital to jump ahead of them in the queue.

69. When Paramount abandoned (it thought) *King for a Day*, it had spent over $400,000 and had not yet made the picture "pay or play." See O'Donnell & McDougal, supra note 2, at 295. One project that was abandoned after the star, Shirley MacLaine, had been made "pay or play," *Bloomer Girl*, has become standard fare in modern contracts casebooks. See Parker v. Twentieth Century-Fox Film Corp., 474 P.2d 689 (Cal. 1970).

70. A recent Whoopi Goldberg film, *Theodore Rex*, was deemed unreleasable by the studio and went straight to video. See Joe Baltake, So Long, Sue Ya Later, Sacramento Bee, July 28, 1996, available in LEXIS, Nexis Library, Papers File. *The House of God* is another example of a film that was never released theatrically. See Steven Bach, Final Cut: Dreams and Disaster in the Making of Heaven's Gate 113 (1985). Bach recounts numerous threats to shut down the disastrous *Heaven's Gate* during production. However, he notes that once a project has been made "pay or play" or shooting has started, termination is very difficult. See id. at 200.

71. The defendants in *Buchwald II* summarized the importance of this option as follows:

> It is important for a studio to retain the right *to not use* a producer's services . . . . Unless the producer in this position also has established "line" producing credentials—a history of successfully managing motion picture productions and working with major stars, writers and directors—studios will typically use the services of an actual producer in which it more appropriately feels comfortable entrusting the millions of dollars necessary to make a movie. Alternatively, if the project attracts a "star," these performers will frequently be attached to their own producers and production companies, and they will demand the right to designate the producer. The studios preserve their options by insisting on "pay-or-play" clauses like that in Bernheim's contract.

King for a Day "pay or play," it could have replaced Bernheim as producer, but only if it paid him his fixed compensation ($200,000).[72]

The option to add high-priced talent is an extremely valuable one. The consultation clause provides for that option according to a predetermined pricing formula. If a net profits participant is added, most or all of his share will come out of the producer's share. If a gross participant is added, both the studio and the net participants dilute their claims to the future earning stream. The studios could, of course, sweeten the deal for the producer by altering the compensation package when the project changes direction. Bernheim's agent suggested that they always do so, surely a litigation-induced exaggeration.[73] A voluntary increase in the producer's compensation might well be in the studio's long-term interest (maintaining good will), but it is doubtful that as a general rule the studio would choose to increase the producer's direct compensation at precisely the moment that the producer's relative contribution to the film's commercial success has been diminished. In any event, if the studio does choose to sweeten the deal, the new compensation package will almost certainly have a higher breakeven point.

IV. Why Take Net Points?

We have a reasonable explanation of why net profits participants might be willing to give up some or all of their back-end compensation when star talent capable of commanding gross points is added to a project. That leaves the prior and more general question: Why use net profits compensation in the first place? Why give Art Buchwald 1.5% of the net for a treatment or Alain Bernheim 17.5% of the net for producing a film? Why, for that matter, give Eddie Murphy 15% of the adjusted gross? Why doesn't the studio simply pay everyone fixed fees and take 100% of the revenues for itself, and why wouldn't the talent prefer that?

Declarations of Defendant Paramount Pictures Corporation, Declaration of Mel Sattler at 39–40, Buchwald v. Paramount Pictures Corp. (*Buchwald I*), 13 U.S.P.Q.2d (BNA) 1497 (Cal. Super. Ct. 1990) (No. C 706083).

72. Bernheim was a "packaging producer," not a "line producer," and would almost certainly not have been involved in production of *King for a Day* had the studio gone forward with the project. While the contract would allow the studio to terminate him paying only his fixed compensation, the industry practice, as I understand from conversations with industry insiders, would be to keep him associated with the picture, with some revision of the compensation.

73. The agent stated:

> I have always interpreted the consultation provision, and I believe it is generally understood in the industry, to mean, at the very least, that the studio has to consult in good faith and with a view to reaching a compromise that is acceptable to both parties, if possible. As a practical matter, Paramount would not have imposed its will on Bernheim unfairly because studios generally, and Paramount specifically, do not do business with their contract producers in that fashion.

Declaration of Roger Davis at 11, *Buchwald I* (No. C 706083).

A. *A Brief Digression*

It is useful to step back and put things in perspective. Contingent compensation is not confined to the contracts between studios and talent. It is endemic in the movie business throughout the distribution chain. It is even the rule in the sale to distributors of completed, low-budget, independent films, a point to which I shall return below.[74] In the standard distribution contract, the exhibitor receives a contractually determined share of the box office gross. The standard subdistributor contract for foreign distribution also involves a sharing rule, typically based on the net rather than the gross. Before turning to our particular problem—the studio-talent contract—it will be instructive to investigate why these contracts take the form that they do.[75] The critical feature is the relationship between the timing of the parties' performance and their compensation.

Consider first the contract between the distributor (for example, Paramount) and the exhibitor (the local theater). The exhibitor could pay a fixed fee for the movie and keep all the revenues for itself, or it could simply charge a flat rental fee for the space, with the distributor then receiving all the revenue. Typically, the parties avoid these extremes, dividing the revenues roughly evenly after subtracting out the so-called "house nut."[76] (Some exceptions to this rule will be discussed below.) The sharing arrangement reflects the fact that the size of the revenue stream is influenced by the efforts of both the distributor and the exhibitor.[77] The distributor launches a massive advertising campaign shortly before a film is released.[78] The exhibitor markets the movie locally (some of this expense being paid for by the distributor through cooperative advertising). By maintaining a large stake in the outcome for both distributor and exhibitor, the sharing formula gives to both an incentive to provide selling effort.[79]

Their efforts are not provided simultaneously, the distributor's effort being more significant in the beginning. The sharing formula reflects that timing. Since the selling effort of the distributor is more heavily front-loaded, a constant sharing formula would give the exhibitor a poor

74. See infra text accompanying notes 93–99.

75. See 2 Yeldell, supra note 11, § 18.02, at 18-17 to 18-19.

76. The house nut is a fixed amount subject to negotiation that ostensibly covers the exhibitor's fixed costs. See Harold L. Vogel, Entertainment Industry Economics 73 (3d ed. 1994); A.D. Murphy, Distribution and Exhibition: An Overview, *in* The Movie Business Book 275, 276–77 (Jason E. Squire ed., 2d ed. 1993).

77. The formula (and the expected shares) can be varied in numerous ways. See A. Alan Friedberg, The Theatrical Exhibitor, *in* The Movie Business Book, supra note 76, 341, 342–49; Murphy, supra note 76, at 276–87; D. Barry Reardon, The Studio Distributor, *in* The Movie Business Book, supra note 76, 309, 313–17.

78. See Robert G. Friedman, Motion Picture Marketing, *in* The Movie Business Book, supra note 77, 297–302.

79. Technically, the parties face a two-sided moral hazard problem since the outcomes depend on the efforts of both.

return on its marketing efforts in the later stages of a film's run. It would be inclined to terminate a run early since it would bear nearly all the incremental marketing costs at this stage yet reap only a portion of the gains. Distribution contracts account for this timing asymmetry by reducing the distributor's share as the length of the run increases. Thus, the typical distribution agreement gives the distributor the greater of two figures: Either it receives 90% of the box office receipts in excess of the house nut or it receives a floor that is typically 70% of box office receipts in the first two weeks and that is gradually reduced to about 35% to 40% by the eighth week.[80] "In the earlier, high-grossing weeks of a run, the 90/10 calculation prevails, while in later weeks the percentage minimums are invoked."[81] The sharing formula is tilted to provide a larger share of the compensation to the party whose effort is most significant at a particular phase of the film's life.

The few exceptions illuminate the purpose behind the arrangement. On occasion the exhibitor pays a fixed fee for the film and keeps all the box office receipts; typically this would occur for a small theater showing a late run, long after the distributor's promotional efforts have ceased.[82] In the opposite extreme, distributors sometimes engage in "four-walling," renting the theater at a fixed fee and keeping all the box office receipts. The four-walling distributor will engage in a massive advertising campaign on local television, essentially taking over most of the local exhibitor's marketing tasks.[83]

The foreign distribution contract also phases the compensation to reflect the timing of the parties' efforts. The studios often enter into foreign distribution arrangements with subdistributors before the movie is completed. When arranging its foreign distribution, a studio could purchase distribution services from the subdistributor for a flat fee. It does not. Instead, the studio enters into a sharing arrangement in which the subdistributor pays the studio a fixed payment plus half the net profits (derived by subtracting from the subdistributor's revenues the initial payment, the local distribution costs, and a distribution fee).[84] In effect, the studio accepts from the foreign subdistributor the same deal that the studio makes with the net profits participants like Bernheim and Buchwald. The compensation can be broken down into three pieces. First, the studio receives a lump sum based on expectations of the yet-to-be made movie's marketability in the local market. The subdistributor then receives all the revenues until the breakeven point is reached. Finally, after breakeven the revenues are divided on a roughly fifty-fifty ba-

80. See Friedberg, supra note 77, at 341, 345–46; Reardon, supra note 77, at 314–17. While there is considerable variation in the terms regarding the floors, according to Friedberg, "virtually every deal is a 90/10 deal." Friedberg, supra note 77, at 348.

81. Reardon, supra note 77, at 314.

82. See Vogel, supra note 76, at 73.

83. See id.

84. See 2 Yeldell, supra note 11, § 18.02(c)(2), at 18-17.

sis. The breakeven point increases as the subdistributor's distribution costs rise—it is a "rolling breakeven."

The division of the first two pieces is nicely coordinated with the timing of the effort of the two parties. The phasing of the compensation is even more extreme than in the distributor-exhibitor contract. Virtually all the studio's efforts to influence the box office in the local market have been made long before the movie appears there.[85] The subdistributor, when determining how much marketing effort to put behind a particular film, finds that it (and its local exhibitors) will receive all of the rewards from local effort up to the breakeven point. Only after breakeven does the subdistributor share with the studio. But that raises the natural question: Why stop there? Why water down the subdistributor's incentives by giving the studio half the net revenues after breakeven has been reached?

Part of the reason, of course, is that a rolling breakeven arrangement, as here, does not water down the incentives very much. True, at the planning stage, when the subdistributor is planning its local distribution budget, truncating the earnings stream reduces the expected value of its marketing expenditures. If the marketing decision were completely irreversible, then perhaps the truncation would result in a somewhat smaller expenditure. But the decision, almost certainly, is not irreversible. As new information becomes available, the subdistributor can adapt its marketing plan accordingly. And at that stage, the rolling breakeven means that so long as the incremental revenues exceed the subdistributor's incremental costs, it will be willing to expand its marketing effort.[86]

Why might the studio (the owner of the film) want to take part of its foreign earnings by sharing revenues beyond the rolling breakeven rather than simply accepting a higher fixed fee? Three explanations are possible. First, since the foreign distribution agreement is often made at an early stage in the project, giving the studio some of the contingent compensation heightens its incentive to produce a film that will appeal to the foreign market. That is, incentives affect not only effort but artistic judgment as well. Second, if the parties must agree on a single price for an asset of uncertain value (the unfinished film), they have an incentive to economize on the production of information about the value of that asset; sharing reduces the value of an informational advantage, allowing the parties to spend less in pursuit of special information and also allowing

85. In a typical release pattern, the film will be shown in foreign markets some months after it first appears in the American market. See Vogel, supra note 76, at 72.

86. Let the increment in revenue be X, broken down into the amount going to the distributor (D) and the subdistributor (S). Let the distribution fee be f and the incremental amount spent by the subdistributor be Y. Then $D=\frac{1}{2}[(1-f)X-Y]$. For the distributor to receive anything, $D \geq 0$, so $X \geq Y/(1-f)$. If X is less than that, all the revenue goes to the subdistributor. The subdistributor receives $S=X-D$ or $S=\frac{1}{2}[(1+f)X+Y]$. So, if the distribution fee is 20% and the subdistributor spends an additional $100, the first $125 of additional revenue will go to the sub as will 60% of any revenue beyond that.

them to consummate the deal earlier, with less information revealed.[87] Third, by accepting some of its compensation in a contingent form, the studio assures the subdistributor of its belief in the quality of the film. The studio is like the seller of a firm who takes part of the price in the form of an earnout, making part of its payment contingent upon the future success of the asset (the firm or the film).[88]

B. *The Studio-Talent Contract*

The studio's role vis-à-vis the foreign subdistributor is just the opposite of its role vis-à-vis the talent. Virtually all the subdistributor's effort comes after the studio has made its contribution to the project. Virtually all the talent's effort comes before the studio's marketing effort. The studio is responsible for the production and marketing costs, and the deferred breakeven assures the studio that it will receive most of the revenues arising from an increase in either production or distribution expenses.[89] The studio receives 100% of revenue until breakeven, just as the subdistributor does vis-á-vis the studio in the foreign distribution. The studio's incentives to develop and exploit the property are preserved by allowing it to reap almost all the rewards. Again, the puzzle is not why the talent get *so little* of the profits; the question is why they get *any*.

The studio does not take all the upside; it shares net profits above the contractually defined breakeven point. The reasons are variations on the themes noted above. For the author of a treatment (like Buchwald), whose contribution is completed before the project has taken shape, making a piece of the compensation contingent simplifies the valuation problem. The sale can be completed before either party has determined how (or whether) the property might be developed.

For a producer who remains with the project, the opportunity to share in net profits serves as a goad both to improve quality and to con-

87. See Yoram Barzel, Measurement Cost and the Organization of Markets, 25 J.L. & Econ. 27, 34–35 (1982); see also Roy W. Kenney & Benjamin Klein, The Economics of Block Booking, 26 J.L. & Econ. 497, 522–27 (1983) (stating that revenue sharing arrangements can be used when quality is variable and difficult to measure, though bundle pricing may be a more preferable solution because it avoids the incentives and cooperative effort problems associated with revenue sharing); Victor P. Goldberg, The Gold Ring Problem (1996) (unpublished manuscript, on file with the Columbia Law Review) (noting that because information is costly to produce, buyers and sellers can economize on information costs with sharing arrangements).

88. See Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239, 262–64 (1984) (noting that when parties' expectations of the quality of a business entity differ, the sale of the firm can be frustrated because parties will not agree on the fitting price; earnout arrangements create deals that make sense even if the parties' estimates of the future value of the firm do not converge).

89. The studio does not usually have complete control over production costs. It will approve the initial production budget and monitor the producer, but the producer will usually have some control over production costs. The net profits clause will sometimes be designed to encourage the producer to control production expenses. See infra note 90 and accompanying text.

trol costs. The producer will often maintain considerable control over the film's costs. Making some of the compensation depend upon cost containment encourages him to balance the benefits of lower costs against those of increased quality and gross revenue. Indeed, a producer's contract often includes an "overbudget penalty clause," which reduces the producer's share of net profits if the film is overbudget by more than a specified amount.[90] As gross participants are added to the project, the producer's influence over both cost and quality of the final product decreases and the incentive effects of the net profits carrot are, naturally, weakened. That is, when there is no exceptional talent taking gross points, the net profits clause provides some incentives to the talent who have a significant impact on the outcome; the incentive effects of the net profits clause fade away precisely when that intermediate level talent has less impact on the outcome.

The larger the share of the distribution budget allocated to the post-release period, the more important are the studio's incentives at the margin. If the studio has the option of continuing to spend on promotion, it is more likely to do so the greater its share of the rewards from that promotion. Because their commercial success depends critically upon the opening weekend's box office receipts, films with top talent allocate a larger share of their promotion-distribution budget to the pre-release phase than do films staffed with lesser talent.[91] Indeed, the presence of the top talent is itself a critical element in the film's marketing. The presence of Eddie Murphy, Arnold Schwarzenegger, or a handful of other top stars can by itself assure a film an opening on a significant number of screens. Moreover, those stars can make a substantial contribution to the marketing of the film, promoting the film to exhibitors to assure wide distribution and to potential viewers on the talk show circuit.[92] By giving these top stars a share of first dollar gross, a studio encourages promotional effort.

At the same time, because the bulk of the marketing budget of a film with gross participants has been committed prior to the release of the film, the adverse incentive of, in effect, taxing the return on the studio's post-release marketing effort is muted. On the other hand, films with less exceptional talent will, in general, have more modest openings and their commercial success will depend more on building an audience over time.

---

90. The clause only makes sense when the producer, or an independent production company, has significant control over the film's expenses. Overbudget penalty clauses work in various ways. They could add an additional increment to production costs if the film goes overbudget (thereby shifting the breakeven outward), or they could reduce the producer's share as a function of the size of the overrun. See 2 Yeldell, supra note 11, § 18.02 (F)(2), at 18-38 to 18-39.

91. For a discussion of the different patterns of marketing a motion picture with a broad release (for example, *Batman*) and a "slow release," which relies on reviews, word of mouth and ongoing marketing effort (for example, *The Color Purple* or *Driving Miss Daisy*), see Friedman, supra note 78, at 292–302; Reardon, supra note 77, at 310–19.

92. See Friedman, supra note 78, at 300–01.

A considerable portion of the studio's marketing effort will be concentrated on the post-release period during which the studio will have to balance the expected benefits of spending an additional marketing dollar against the costs. Efficient exploitation of this type of movie is enhanced with a rolling breakeven, which allows the studio to recoup its incremental post-release marketing expenditures before sharing any revenues. Thus, the pattern of contingent compensation that we observe—first dollar gross for top stars, adjusted gross for the next tier, and net for the next—is consistent with the timing of the studio's marketing effort.

Most net profits participants enter into their contracts long before the picture is completed. The net profits structure reflects the timing of their contributions to the commercial success of the movie and the importance of maintaining incentives at the various stages of the project's life, particularly the incentives of the distributor. There is one notable class of exceptions—independent films sold to distributors after completion—and this class enables us to view the net profits clause from a different angle.[93] Independent producers will typically produce a film without having prearranged the distribution rights. They will then try to market the film to a distributor, often by exhibiting the film at a festival.[94] While most such films are small, relatively inexpensive and of dubious commercial value, a few achieve commercial success, for example, *She's Gotta Have It*, *Reservoir Dogs*, *sex, lies, and videotape*, *Roger & Me*, and *Hoop Dreams*.[95]

These deals virtually always include net profits.[96] The producer buys services from a distributor just as the distributor buys services from the foreign subdistributor. And, rather than paying directly for the service, the producer receives a fixed fee and the distributor keeps all the revenue until breakeven, after which the revenues are divided. The contract comes too late in the project's life for the net profits to influence the producer's behavior in making the original print. Still, net profits can influence the producer's behavior in two respects. Between the date of acquisition and the film's commercial release, the film can be reshaped in various ways to make it more marketable.[97] The producer can also play an active role in promoting the film. Michael Moore, for example,

93. For an idiosyncratic and entertaining look at this segment of the film industry, see John Pierson, Spike, Mike, Slackers & Dykes: A Guided Tour Across a Decade of American Independent Cinema (1995).

94. See id. at 26–30. Numerous films were sold at the 1996 Sundance Festival, two going for $10 million in spirited competition. See Amy Taubin, The Snowball Effect: Dealing at Sundance, Village Voice, Feb. 13, 1996, at 72.

95. See Pierson, supra note 93, at 62–66, 127–28, 149–50, 210–11, 323–27.

96. See Ira Deutchman, Independent Distribution and Marketing, *in* The Movie Business Book, supra note 77, 320, 324.

97. For examples, see Pierson's discussion of the post-acquisition, pre-release changes in *She's Gotta Have It*, Pierson, supra note 93, at 66–78, and *Roger & Me*, id. at 152–76.

agreed to be available for a six-month period to promote *Roger & Me*.[98] The producer's continuing role in the commercial success of the film goes a long way toward explaining the use of contingent compensation for the sale of a "completed" film. As noted above, the net profits formula maintains the distributor's incentives at the margin. For every dollar spent by the distributor, the first $1.30 or so (depending on the distribution fee) of revenue goes to the distributor. This is of crucial importance for small, independent films since such a large share of their promotional budget is allocated to the post-release period.

Net profits compensation for the independent producer-director might play two other roles as well. In part, the contingent compensation bridges a difference of opinion. If the producer's view of the commercial value of "his baby" is systematically more rosy than that of the distributors, the expected value of the back-end will be greater for the producer than for the distributor. This explanation relies upon the systematic relative optimism of the producer-director. Alternatively, by reducing the value of divining the right price, net profits can serve to reduce the costs of haggling over the film's commercial value.[99]

V. Conclusion: The Diminishing Likelihood of Net Profits

The public perception of net profits clauses is, I think, that talent are entitled to a share of the earnings of a film and that the studios have manipulated the clauses to make it unlikely that the talent will reap their just rewards. I start with the notion that it is not at all obvious that any contingent compensation is in the interests of the talent because any sharing rule waters down the studio's incentives to spend money on producing and promoting the picture. The harder question, I have argued, is why the studio shares as much of the film's revenue stream as it does with the talent. I conclude that giving the net profits participants a share of the back-end sharpens their incentives both while the film is being produced and afterward if they are to be involved in promoting the film. It also facilitates early contracting in the context of imperfect and asymmetric information. The fact that the studio-talent clause is structurally close to the studio-subdistributor contract (but with the studio taking the

98. See id. at 156. Pierson provides numerous examples of the role of independent producers in actively promoting their films after they have signed a distribution agreement. The promotional role of the independent producer/director is emphasized by Ira Deutchman, president of Fine Line Features:

> [K]eeping the filmmakers happy is essential to a successful campaign, since we have to depend on them to go out on tour, doing interviews with regional press. Because independent movies are more director-driven and review-driven than studio pictures, much weight is placed on the filmmakers' shoulders to help us position the picture in the marketplace.

Deutchman, supra note 96, at 325.

99. For a detailed description of the haggling over the advance on *Roger & Me*, see Pierson, supra note 93, at 139–65.

back-end in the latter) suggests that the clause is being used to resolve the same problems there.

Granted that there are satisfactory reasons for sharing some of the film's contractually defined net profits, the question that naturally arises is why the formula results in so few payouts. It is part of the semantic confusion in this industry that the largest component of the net participant's expected compensation is labeled "fixed" but is, in fact, contingent. Most projects are terminated early, with the net participants receiving modest development fees but no fixed fees. Of those projects that do make it to the screen, in most instances the net participants receive only their fixed fee. Net profits participants, I have argued, agree in advance to give up their priority to claims on the future revenue stream in certain circumstances. In particular, when a gross participant is added to the project, even though the likelihood of receiving net profits from a successful movie might fall, the expected value of the net profits participant's overall contract will increase. The gross participant's presence increases the likelihood that the project will actually go into production and that means that the net profits participant is more likely to receive her fixed compensation.

Not only is the likelihood that a studio film will yield net profits low, but industry observers agree that the likelihood of a payout has declined in the past two decades. In part, this is attributable to rising production and distribution costs. In addition, there has been an increased skewing of earnings, with the payments to top stars increasing relative to those going to the net participants. The value of top stars has been enhanced both because domestic box office revenues have become more dependent on a film's performance in its opening weeks[100] and because foreign exhibition accounts for a much larger share of receipts today than in the past.[101] As a consequence of these two factors, the breakeven point for net profits participants has been receding, commensurate with their decreased contribution to the commercial success of a movie.

---

100. For most studio pictures, a considerable portion of the domestic box office revenues are generated in the opening week. *Batman*, for example, earned $40 million in its first weekend and by the end of the second weekend had earned nearly 50% of its $250 million domestic box office gross. See Friedman, supra note 78, at 292–302. The presence of a major star can substantially increase the number of screens on which a film opens and, therefore, the initial box office receipts. Only a handful of stars can assure that a film will open on 2,000 screens. In 1989–1994, less than 7% of all films reached the 2,000 screen level. See Reynolds, supra note 2, at 97, 105. The average domestic box office receipts for those movies was $93 million, three times that of the average major studio movie. See id. The total number of screens is only about 25,000, see id. at 94, so these films would be playing on 8% to 10% of all domestic screens at one time.

101. By the mid-1990s, foreign exhibition accounted for roughly 50% of studio revenues. See Horowitz & Davey, supra note 16, at 463.