Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Audit Trend Puts Movie Studios Up In Lights

Law360, New York (January 07, 2013, 12:39 PM ET) -- A recent entertainment industry trend has seen profit participants, or "talent," aggressively auditing and suing major movie and television studios to force them to properly account for the profit participants' back-end royalty payouts. These audits and subsequent lawsuits are poking holes in studio accounting systems and uncovering several improprieties, such as the studios packaging successful films and television series with less successful films/series or those that have not reached the threshold for profit participation, and/or licensing a successful film or television series to an affiliated cable network for less than its value. The profit participants have alleged that studios engage in these improprieties to keep more money by lowering the amount they have to pay to profit participants. Two recent cases, and big wins for profit participants, Celador Intern. Ltd. v. Walt Disney Co., 347 F.Supp.2d 846 (2004); and Ladd v. Warner Bros. Entertainment Inc., 184 Cal.App.4th 1298, are putting studios on the defensive.

The legal cornerstone for any audit case is the implied covenant of good faith and fair dealing, which every contract in California implies. This provision requires that neither party engage in conduct that will injure the right of the other to receive the benefits of the agreement. It has been held that the implied covenant finds particular application in situations where one party is invested with a discretionary power affecting the rights of another, and requires that such power be exercised in good faith. In audit cases like Celador and Ladd, profit participants have asserted that studios can deprive profit participants of revenue by using their discretion over licensing agreements to manipulate deals to the studios' advantage.

In Celador, the plaintiffs (profit participants) alleged that defendants (the Walt Disney Co.) violated a contract in several ways. The profit participants alleged that Disney "entered into agreements with affiliated entities on terms that are not fair and reasonable; permitted affiliated entities to become delinquent in their obligations to make payments in connection with the production and distribution of a television series; refused to provide documentation to substantiate that the terms of their dealings with affiliated entities are fair and reasonable; failed to properly exploit the series and pay plaintiffs their share of revenues; failed to renegotiate contracts in a manner consistent with industry custom; and inflated production costs."

As you might think, the profit participants alleged that these actions violated the covenant of good faith and fair dealing because they "intentionally frustrated the profit participants' enjoyment of their rights under the contract." The jury in Celador found that the profit participants' allegations were supported by evidence and awarded $269 million in damages against Disney. Although Disney challenged the jury's finding and award of damages, the Ninth Circuit recently rejected Disney's argument and upheld the jury's verdict and damages award.

Ladd primarily involved the practice of "straight-lining," in which Warner Bros. would sell a package of films to a television or cable network and allocate the total amount of the package equally to each of the films in the package regardless of the value of the film. Alan Ladd sued because straight-lining did not reflect the value, quality, or desirability of any given film in the package. Testimony in the Ladd case revealed the behind the scenes workings of Warner Bros.' packaging deals resulting in adverse treatment of profit participants.

For example, Eric Frankel, former president of Warner Bros. domestic cable distribution, testified that Warner Bros. initially assigned each movie a grade of A, B, or C when evaluating movies. There is no licensing demand for individual C movies and they are "relegated to filler material," which is why they are bundled in a package together with A and B movies. The profit participants alleged that including C movies in a total package lowers the amount of money that can be allocated to each film in the package, which effectively lowers the amount that the studios have to pay to profit participants involved with the A and B movies. Along these lines, in the Ladd case, Leslie Cohen, director of film acquisitions at HBO, testified that in one licensing deal, Warner Bros. added a group of old Tarzan movies to a licensing package at no cost and Warner Bros. then allocated a license fee of $40,000 to each of the Tarzan movies, thereby reducing other films' allocations in the package.

In addition to the claims made in Celador and Ladd, profit participants have complained about how studios conduct audits. For example, when profit participants first demand an audit under their respective agreements, the studio will put the profit participant in what has been called a "queue," which is a long line of audit-seeking profit participants. This delays the audit by up to 18 months, which some profit participants have asserted is a violation of the implied covenant of good faith and fair dealing because it frustrates profit participants' audit rights under their respective agreements, and during that waiting time the studios and networks retain money likely due to profit participants.

Profit participants also allege studio misconduct during an audit since studios give the profit participants only a summary and/or a sampling of the licensing agreements that are the subject of the audit rather than full documentation. Profit participants have asserted that this is a considerable impediment because their allegations of misconduct against the studios can only be discovered through a thorough review of the underlying license agreements. In the future, it is anticipated that profit participants, emboldened by the large victories in Celador and Ladd, will litigate these complaints.

Studios often assert a key protection that profit participants' respective agreements contain a provision limiting the time within which the audit must be conducted and within which a lawsuit must be filed. The profit participants lose the right to bring an action and conduct an audit if they do not perform the audit within that contractual time period, even if they are owed millions of dollars. However, as demonstrated in the music auditing case Weatherly v. Universal Music Publishing Group, an action can be brought outside of this contractual limitations period when the studio misrepresents payments on royalty statements. Weatherly thus potentially permits profit participants to reopen the contractual limitations period and the larger statute of limitations period and, in a lawsuit, seek damages from the commencement of the contract if the profit participants can prove they had no knowledge of the studios' misconduct through the studios' misrepresentations on the royalty statements and/or during the audit process, which is fraud. If they make any misrepresentations on royalty statements or play games during the audit process, studios and networks may lose a key defense.

It is likely that studios are in for a harder fight on audit issues in the coming years because of major losses in Celador and Ladd. Look for profit participants to aggressively audit and bring lawsuits more frequently. It is anticipated that studios will likely be looking for ways to protect themselves and avoid audits by adding stricter auditing provisions to their various agreements with profit participants. Also, expect studios and networks to attempt to obtain waivers from profit participants that any film or television series licensing agreements will be subject to the sole discretion of the studio. Studios may also attempt to have the profit participants acknowledge that the studio can license the film or television series to an affiliated company and not engage in an arms' length transaction. Another additional protection that studios may impose on profit participants is stronger dispute resolution provisions requiring arbitration or to turn over the dispute to a third party auditor, who will perform a binding arbitration.

Regardless, with studios and profit participants seeking every form of revenue possible, these cases are here to stay and likely will be more contentious and aggressive. And, as a result of Ladd and Celador, the foreseeable trend is that studios will be forced to turn over records and defend business techniques that help the studios book maximum profit.

--By Bryan M. Sullivan, Early Sullivan Wright Gizer & McRae LLP

Bryan Sullivan is a partner with Early Sullivan Wright Gizer & McRae in the firm's Los Angeles office.

The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.