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A Case Study: Guild Residual Calculations - Studio vs. Independent Film Models

The Writers Guild of America (WGA), Screen Actors Guild (SAG), and the Director's Guild of America (DGA) track the international box office, DVD, VOD and television revenues of films around the world in order to assess the correct residual amounts for their members. The challenge facing the Producer however is that the Guilds utilize the same accounting methods to assess royalties with independently financed films as they do the studio financed films, and therefore the producer can be overcharged dramatically on an indie film.

The studios are a one-stop shop—they funnel both their investment and distribution through in-house channels and therefore have made decisions regarding the level of theatrical distribution vs. DVD/VOD/Television a film will receive before it is made. This level of control allows them to produce films without securing minimum guarantees from outside entities, and thus are able to easily generate at-source revenue statements for residual purposes..

This is critical to understand: the Studios get actual numbers for theatrical, DVD, VOD and television sales and the Guilds can correctly generate residual calculations—important information given that Guild residuals are paid as a percentage only on the non-theatrical windows.

The independent production finance model usually requires the engagement of a Sales Agent (who can also act as the producer) to generate pre-sales of distribution rights to third party distributors in each territory. The financial consideration given by a distributor in exchange for the local distribution rights is usually expressed as a Minimum Guarantee (MG). These third party distributors are then responsible for generating the at-source revenues, and are responsible for generating revenue statements, which they don't always do. There's the rub: the sales companies are frequently not forthcoming or unable to report actual sales numbers, and the Guilds must then calculate residuals based on the MG (a projection of sales,) rather than the actual sales numbers. And this can affect the residual numbers greatly as most films do not perform as well as projected.

The respected entertainment attorney Schuyler Moore starts the second chapter of his guide to the film business, THE BIZ (Silman-James Press, 2000, p. 11), with the heading, "MOST FILMS LOSE MONEY!" In fact, many films fail to even recoup their theatrical release expenses. The industry bible, DAILY VARIETY, often features stories of significant write-downs. Here is one article presenting the potential losses and possible write down on the Warner Brothers film JACK THE GIANT SLAYER and how it relates to the known Disney flop JOHN CARTER.

Box Office: 'Jack' Looking Like Giant Disappointment at $23 Million

> It doesn't look like there will be a fairy tale ending for Warner Bros.' "Jack the Giant Slayer." The $200 million-plus budgeted retool of the "Jack and the Beanstalk" children's story bowed to $7.7 million Friday, and is looking at a three-day gross in the low $20 million range.
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> It's too soon to say if this will be a flop of "John Carter"-sized proportions. That Disney tentpole bowed around this time last year to $30 million, and turned into a $200 million write-down for the Mouse. [1]

Let's look at the concept that the Studio system of allocation favors the Studios when the film loses money and can cost the Independents greatly with respect to required residual payments. Though the write down for JACK isn't known publicly, the article mentions that Disney wrote down $200 million in costs for JOHN CARTER (the movie was rumored to have cost $250 million and global marketing costs might have added $100 million to that.)

As discussed, based on the creative elements of the film, Disney's distribution division would have projected sufficient revenues to cover production and distribution costs prior to the film being approved for production.

This is analogous to the process by which an Independent film is funded through agreements with international and domestic distributors (the MG) to pay a fixed amount and in many cases to agree to spend an additional amount on release costs. Again, for simplicity we will say that the entire $250 million budget is funded through pre-sales in the Independent model. To be clear, the process that the individual distributors go through in negotiating their MG amounts is like the process Disney goes through to decide how much to invest in the film.

The difference is that the Independent film must pay residuals based on the <u>pre-sale amounts</u> that funded the budget, whereas Disney will only pay residuals on the film's <u>at-source revenues</u> in non-theatrical windows. If they wrote down $200 million after spending a total of $350 million then we should assume that this amount was $150 million (and about 1/3 of that was from theatrical revenues, leaving **$100 million** to allocate towards residual payments.)

Obviously the distributors made the decision to invest heavily because the film was perceived to be a theatrical title. Disney, though, pays residuals on $100 million while utilizing the MG method, while the Independent would pay residuals 75% of $250 million (The MG) or **$187.5 million**. Clearly this method represents an unreasonable allocation process.

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[1] Box Office: "Jack" Looking like a Giant Disappointment, by Michael Sullivan Variety 3/2/13

It bears repeating that most films lose money – though hopefully not as much as JOHN CARTER and JACK THE GIANT SLAYER. In percentage terms, though, losses like this are very common and I have seen many distribution statements on Independent movies from Major Studios (where they have handled domestic or select foreign territory distribution) and other distributors where only a small portion of the MG was recouped. Thus it is not fair or reasonable to assess residuals on 75% of the MG, because often times the MG is not recouped and does not come close to representing a model for at-source revenue allocation in the absence of factual reports, which are often not possible to obtain.

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Establishing the MG

Many factors go into establishing the MG for a particular film in a particular territory. The theatrical release of a film is the key factor in creating value for most films. The money spent on the release (P&A or "Prints and Advertising") create awareness for the film, secure an initial theatrical audience which then leads to successful distribution in the ancillary markets such as DVD and Pay/Free TV. Access to theatrical-level films is extremely competitive and the distributors often have certain needs to fill irrespective of potential profitability. (i.e. A distributor may need to have a certain "big name" title in order to gain access to shelf space for the other films they are distributing even if that film may create a loss for them.) This is not the case for films going straight-to-DVD or TV.

Often MG's bear little relation to at-source revenues. International distributors will make their decisions on how much to pay as an MG on factors such as cast, director, script, budget and U.S. release plan. For most theatrical features the rights outside the U.S. are sold long before

the production even starts. The value of a U.S. theatrical release to a local distributor outside the U.S. cannot be overstated. Often MG's in overseas territories will increase substantially - based solely on the fact that a film is set for a U.S. theatrical release – long before that release occurs.

The MG is derived as a function of the skill/clout of the sales agent and the needs/willingness to pay of the distributor. Potential at-source revenue of a film in a local market is one factor that is weighed by a distributor in that territory, but it is not the only factor. As mentioned above, many components go into the buying decisions of distributors. It is not just driven by estimates of revenues for that specific film. In my experience, it is relatively rare for a distributor to recoup or earn revenues higher than the MG, and therefore be required to pay additional monies based on the revenue splits outlined in the distribution agreement ("overages").

The Independent Finance Model

As mentioned, most independent theatrical films sell territorial distribution rights to local distributors in order to collateralize production loans. The sales agent, who is often also the producer or executive producer, looks at the major territorial distributors as partners in spreading the huge risk of financing a film. The distributor's financial commitment is made in advance of the film being shot knowing that they will be committing significant additional monies and resources to the film's potential success. These monies are for prints and advertising, dubbing costs, cost of materials, staff time and other factors that will affect the potential at-source profitability of a picture.

In the Studio model, Studios can identify, quantify and account for these costs in their accounting as they are vertically integrated. In the Independent Model, these costs are outlined in territorial distribution agreements and accounted for when and if statements are received from the distributors. It is often challenging and sometimes impossible to obtain those revenue statements, but even the best of statements do not provide sufficient information to mirror Studio-level accounting.

<u>The Independent Revenue Reality</u>

Whereas Studios are organized to report net revenues at source to the guilds, most of the time the sales agent does not have access to sufficient information to provide this data. In most cases they will only receive the gross amount of the MG, which, as stated above, is based on many factors besides the at-source net revenues. Based on review of thousands of these statements over the years, it is my opinion that in many cases a local distributor might recoup their out-of-pocket expenses and have taken their distribution fees long before the MG is fully recouped. This is not unusual or improper and shows that the MG is not a function exclusively of at-source revenues.

Furthermore, it is my experience that it is rare for a sales agent to receive reliable and timely statements from distributors. A case in point is Metropolitan Films in France (one of the top distributors in the country,) who usually have a clause in their agreements that states that they do not need to submit statements of revenues unless they are paying overages. Prior to that “break point”, they would be under no obligation to report at-source revenues. At least Metropolitan is up-front about not issuing statements. In most cases it is simply impossible to get the distributor to comply with their reporting requirement when there is not compelling evidence that a film has performed to a point where overages are likely.

Though it is the responsibility of the sales agent to obtain these reports, in practice they will not push too hard as they are intent on selling that distributor other film rights, and do not want to damage their relationships. The sales agent and producer usually have audit rights which are difficult to exert even if they were willing to potentially damage their relationship with one of the limited numbers of local distributors in a territory. Auditing is a costly and often a fruitless endeavor in overseas markets.

A further reality is that there are many financial factors relevant to a film’s local value (as reflected in the MG,) that are impossible for a sales agent to grasp or account for. Local distribution support (financial or in the form of black-out days and quotas), prestige (a quality theatrical film can help a company in many ways even if it is not technically profitable), co-

production considerations (a local co-producer might also be the distributor and derives benefits that are not accounted for based on their function), packaging (a theatrical title might carry a package of titles or in itself might be carried by a strong title), etc. Clearly these factors figure into the MG and are all based on the film being perceived as a theatrical title. The value of that perception of the film as "theatrical," though impossible for the sales agent to specifically quantify, informs the allocation of the MG amongst the various media. This can be substantially based on a sales agent's long exposure to the market or discussions with the local distributor, but the final MG allocation does not necessarily reflect the eventual actual at-source revenue of a particular title.

Given all of these factors that are unique to the independent distribution model (the Studio model relies on full access to all of this data), in my opinion it is impossible to base an allocation of MG revenues on actual distribution proceeds. The only way to accomplish a fair allocation is to consider the overall "value" of the rights being licensed. That means taking into consideration a number of intangible factors noted above as well as the potential boost to ancillary (DVD/VOD/TV) revenues from the theatrical release of the film.

Establishing a Logical Allocation for Residual Purposes

Due to the twin difficulties of determining at-source revenues from various media as well as what "value" is added by the theatrical nature of a film, it is meaningless to allocate MG revenues across media based on ratios of at-source revenue for those media (even in the rare circumstances when that information is available.)

POSSIBLE SCENARIOS:

1) Film Marketed and Produced with Intention of Significant Theatrical Release but Unsuccessful

MG Germany = $1 million but at-source revenues are under $500,000 and almost all from ancillaries. MG attributable to theatrical should still be more than 50% because the theatrical nature of the film is why the MG was so high, and why the film earned revenues in the ancillary markets.

#2 Film Marginally Successful Theatrically

MG Germany = $1 million and at-source revenues of $750,000 but only 25% from theatrical. However, this title is the only reason TV giant Sat1 was willing to buy a package of ten films

from distributor (assumes allocation in TV package by distributor properly allocates package sale price). Full MG not recouped but distributor still received what they considered "full value". Significantly more than 25% and possibly as much as 50% of the MG should be allocated to the theatrical value.

#3 Film Theatrically Successful

In this case the theatrical success of the film drives not only the ancillary revenues on this film but also raises prestige of distributor and proves value for packages. Try as they might, the sales agent cannot get a full accounting from the distributor but knows the film has been theatrically successful. The theatrical success drives the overall value of the film to the distributor and the MG should be allocated accordingly.

#4 Film Distributed By a Studio

Accountants at the main office take internally generated data from international offices around the globe and condense it to a statement of net revenues, after deduction of expenses and fees

for each category of rights, and residuals are paid in accordance with guild agreements. Since no MG is paid there is no real pre-conception of value to allocate between the rights. Since the at-source revenue information is reliable and available using the actual figures makes the most sense.

In my opinion it is logical to assign a portion of an MG based on the actual perceived value of the various rights licensed by the distributor. Given market trends during the past 10 years (decline in value of ancillary revenue sources and rise in the value of film perceived to be theatrical), it is entirely appropriate to assign a majority of the value of a truly theatrical film's MG to the theatrical rights and smaller amounts to the home entertainment and TV rights. This value will vary based on the individual film but in my opinion would never be less than 40% and in many cases will exceed 50%.

While serving as an Expert for a production/distribution company who was being sued by one of the major guilds to pay outstanding royalties on a slate of pictures, the fundamental difference between the way Studios and Independent production/distribution companies finance and distribute films became very apparent.