

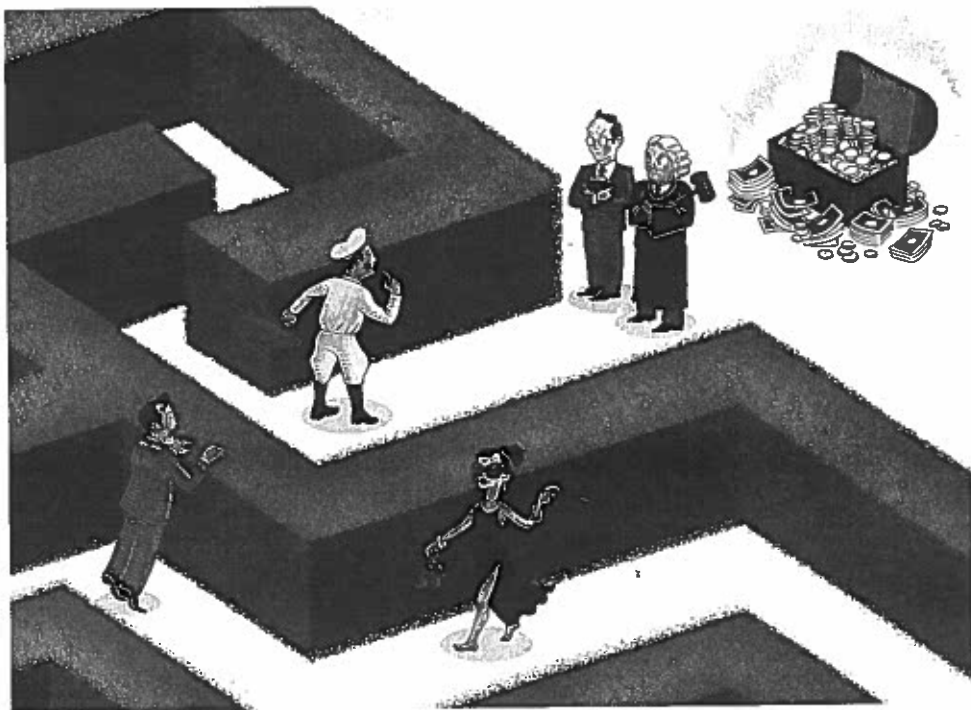
How Studios Are Hurt By Phony Profits

Bones and Walking Dead talent allege they're victims of Hollywood's infamously shady accounting as a producer offers a solution to pay filmmakers fairly and incentivize cost-effective work

By Gavin Polone

ONE WOULD THINK THAT directors, actors and producers, the main profit participants on studio movies, would see it in their best interest to keep costs down, creating greater profit for themselves. Yet the rule, from what I've seen and heard, is that those at the top of the movie pyramid undermine their projects' profitability through wasteful behavior. It's sadly common to witness directors figuring out what they will be shooting when they arrive on set, with the crew standing around doing nothing; actors showing up late and/or keeping everyone waiting while they do whatever movie stars do in their luxury trailers; or producers who are rarely present and, when they are at work, acting more like Walmart greeters than stewards of the budget. Maybe those entitled few already have too much money to care about inconveniencing themselves to make more, or maybe they're all idiots who don't get arithmetic. I'm sure some of both are true, but I believe the seemingly counterintuitive behavior by profit participants has more to do with the fact that studio accounting is at best deceptive and at worst a sham. Why should key artists work to save the studio's money if they believe the studio will screw them on theirs?

The other day, unprompted by me, a man with no connection to the entertainment industry asked me, in heavily accented English, "Why are people in your business



George

so crooked?" He knew nothing specific about studio finance but had the idea that participation accounting is less than fair. I've found most studio executives don't know much more about the topic than anyone else. Recently I asked a former longtime major-studio production president if he ever was involved in a discussion about how to minimize what is paid out in profit on an already-negotiated contract, and his answer was, "Never." Nor did he believe his boss or his boss' boss were involved in such things. The creative executives at the studios are the people who make and sell the burgers; it's only the relevant accountants, financial officers and some in the legal department connected with the resultant lawsuits who ever peer into the slaughterhouse of participation accounting.

"The feeling was that paying out to the participants was spending the studio's money, not that it was the participant's money to begin with," a former manager of participation accounting at a major told me. "When I would go to my boss' office with small checks, she would let them through — they liked paying out small checks. But if I went in with a big check, like over \$100,000, they would say: 'I want you to go over this again. We can get this down by half.' We definitely would come back with a way not to pay people."

Says Jim Perry, a partner at motion picture and television

participation auditing firm Hacker Douglas: "The studios are very smart; they are going to take the position that is beneficial to the studio. Our job is to look at it from the participant point of view and put the issues on the table." According to Perry, those issues fall into two categories: 1) mistakes; and 2) differences in interpretation of contracts.

Perry offers as an example of a mistake his catching a studio charging 10 percent overhead on advertising for a film, even though the contract explicitly said there would be no overhead charged on advertising. While Perry didn't think the studio intentionally disregarded the contract, from my experience, and those of others I know who have audited studios, there are *always* mistakes, and it is difficult for me to believe all of these "mistakes" lack intentionality. This is especially glaring in the context of how nearly every audit turns up extra cash due to the participant and almost *never* shows the studio overpaid someone.

Attorney Neville Johnson, who recently secured a \$26 million settlement from Universal in a class-action case related to the underpayment of home video royalties, presents another angle on these "mistakes": "Let's say you discover 'wrongful accounting' for a profit participant. Do you think they are going to correct it for every other profit participant that may have suffered similarly?

No, they don't." Part of the problem, explains Johnson, is that prior to auditing, "every auditor has to sign an agreement maintaining secrecy about what he learned from auditing a film. Therefore they can't tell one client about what they found out on behalf of another client on the same project." And because mistakes are lumped in with differences of opinion in a negotiated settlement, he adds, "the studio is never going to cop to it and say, 'What we did was absolutely wrong' — they're going to say that it was part of the settlement." In this way, what might have been an innocent error becomes a lucrative occurrence that can be dealt with in one case and overlooked in others until someone finds the "mistake" again in a separate audit, if ever.

Even more costly to artists than mistakes are the extreme positions studios take in interpreting contract language. Litigator Eric George represented author William Peter Blatty in his case against Warner Bros. in 2010 related to profits on *The Exorcist*. As George explained to me: "He had one of the greatest deals ever. [Blatty] was entitled to 28 percent of the net profits, but his share of those profits would never be less than 16.5 percent of the gross profit. But they said he wasn't due anything. He was cheated by the way Warner Bros. interpreted the definition of 'gross.'" During litigation, George found that those charged with



Deschanel

determining Blatty's profits hadn't even read his contract. Warner Bros. ultimately settled.

Other common differences of opinion between studios and artists include:

Straight-lining To business manager Mort Kessler, this practice is one of the most infuriating: "It's always the toughest claim when our client's participation is a project that is valuable, and it gets sold together with other projects that are not in profit — to TV or whatever — and the less valuable parts of that package get a disproportionate allocation of the revenue." Obviously, if a cable network in Latin America buys a group of movies from a studio, it is more interested in, and paying more for, the hits in that assemblage than the bombs. But if the studio ascribes each title an equal share of what was paid, then the unprofitable films — which will yield no payouts to their profit participants — help the studio reduce revenue for those in profit and, therefore, the amount it will have to pay out to participants.

Subcontracting to sister companies Whenever possible, studios have their affiliates function as vendors on their projects. Examples include renting out soundstages, offices or equipment for a movie; distributing a film in a foreign territory; or even selling a movie to a cable network the studio also owns in exchange for a piece of ad revenue. How does a filmmaker know if the studio is getting the best deal from an affiliate? There is rarely, if ever, a bidding process. And if it is a more complicated function where money is being spent and collected, how does one know if the sister company is accounting properly to the studio?

Recently I was on a conference call with a production company about the results of an audit when the representative of one of the other participants asked if the company had audited an affiliate who provided services on the project. "Oh, it is not our policy to audit our sister companies," said the executive. If that is so, and it usually is at major media conglomerates, what incentive would different divisions of a corporate parent have to account properly to their affiliate

clients? If they were to charge too much in expenses or underreport revenue, or both, on a project, they know they'll never be caught because it is stated policy that nobody will check. And the result will be a better showing for their department, larger bonuses for the executives in that department and more profits for the corporate parent.

Foreign taxes A project is charged for taxes paid in foreign territories, but there is no credit given for the reduction of money owed on the company's U.S. tax return. Under U.S. tax law, the corporate parent is allowed to take a credit for foreign

taxes paid on its U.S. return. That's the same as receiving cash. When asked about this, the studio always represents that it doesn't get the credit (even though the company that owns the studio does) so it has nothing to do with the profit the studio pays out.

Waiting time This isn't exactly a difference of opinion but more of a tactic. Once you receive a statement on a movie, you usually have two years to ask for an audit of that statement period. The studio then makes you wait in a queue for one to four years to begin the audit. The reason, they claim, is that they don't have enough people available to lead the auditor through his work. Of course, these companies usually have 8,000 to 20,000 employees, so it is difficult to believe they couldn't hire more people to accommodate everyone's audits within a reasonable amount of time. Delaying audits not only allows the studio to use the cash for years but also weakens the participants' resolve to fight for a fuller settlement of their claims because their capital has been tied up for so long.

ONE MIGHT THINK THERE IS NO real problem here if participants can both audit and litigate when they feel they are not receiving their due, as have Frank Darabont on AMC's *The Walking Dead* and the producers and actors on Fox's *Bones*. But most participants never audit, and even fewer ever sue. The main reason is cost: If you think you might have been underpaid \$80,000, are you going to move forward with an audit that probably will cost \$50,000 and take years to resolve? If your auditor turns up \$250,000 in claims against the studio, are you going to sue when the cost of going all the way through

fleeing artists on profits is bad business for the studios because disengaging those artists from the true profitability of their work leads to the increased cost of that work. It helps them rationalize wasting the studio's money. If you are staying in an overpriced hotel, why not take a few pens and a robe? Except in this case, some are pulling TVs off the wall and packing high-thread-count sheets into their luggage. And the effect of studio productions costing more than they should could exceed, in the aggregate, fairer payments of profits owed to filmmakers because most movies are not profitable — and the price tag of those bombs drops to the studio's bottom line no matter what, while profits are paid out only on a lucky few.

Traditionally these types of problematic business schemes are corrected when whistleblowers step up and class-action lawsuits are filed. That certainly could be what ends up happening here. But a smarter resolution would be if a forward-thinking studio head — who, as I said, probably doesn't know much about how profit participations are handled — were to educate him or herself and offer a better deal to those who make films at his or her studio, a deal that makes it crystal clear that bringing down a project's budget by eliminating waste will yield a larger backend payment for the artist without the delay, cost and frustration associated with auditing and suing. This plan would have to include an independent auditing organization that would set proper accounting standards and investigate practices. The outcome of this new paradigm would be more artists wanting to work at the studio that changes its policies first and their being more attentive to how the studio's money is spent on those artists' projects. In the end, the other studios would follow whichever institutes a better method for handling participations — just as they have followed one another during the past decades to build the defective, unjust system we have now — and the business as a whole would be more efficient and less "crooked."

Gavin Polone is a producer-director.

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a trial might be \$1.5 million and there is no "loser pays" provision to recover legal fees in your contract?

Other than cost, how many people with a large unaddressed claim against a studio are really going to take it on? As Johnson tells me, "Our clients tend to be the families of people who are deceased or people who are no longer working in the industry — because anybody who is still working doesn't want to alienate the studios and ruin their chances of being part of one of their projects."

When you look at it from the studio's perspective, its manner of paying, or not paying, might make sense financially. If it legitimately owes an aggregate of, say, \$1 billion to participants, and only half audit, and then 95 percent of those people settle their claims at 40 cents on the dollar rather than sue, the studio saves itself \$810 million. If it then pays an amount equal to 100 percent of the claims, including legal fees, to the remaining 5 percent who are willing to sue, it is still ahead \$760 million.

On the contrary, I would say

