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COVER STORY

In Hollywood, digital profts a growing point of contention

Alexander Drecun / Special to the Daily Journal

Entertainment litigator John V. Berlinski recently joined Kasowitz Benson Torres & Friedman from NBCUniversal and plans to focus his practice on digital profits disputes. Graphic

By Kylie Reynolds
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Sites that stream television shows and movies online have made their mark on consumer habits, driving down home video sales and bringing TV shows and movies to handheld devices. But it's only recently that digital plays have begun impacting behind-the-scenes profit negotiations between entertainment studios and talent. The deals just weren't lucrative enough be a primary focus, said Stroock & Stroock & Lavan LLP entertainment litigation partner John M. Gatti. But as consumers increasingly turn to services like Netflix and Hulu, digital revenues have steadily been on the rise — and disputes are expected to follow.

"It's a world where individuals no longer need to tune into their living room screens," said John V. Berlinski, an entertainment litigator and partner at Kasowitz Benson Torres & Friedman LLP who previously served in-house at media giant NBCUniversal Inc.

As streaming sites continue to grow in popularity, studios and talent are starting to clamor for their share of the profits. But it's falling on attorneys from both sides to mesh endlessly evolving technology with the entertainment industry's longstanding profit agreements.

"It's just starting to cross the point where it's now becoming more of an issue, because the deals being made are more profitable," Gatti said.

Profit participation agreements, a longtime industry staple, determine how a studio and directors, producers, actors and other talent divide profits. A number of factors go into determining the ultimate figure, including gross revenues, distributions fees and costs and expenses.

But as consumers change their viewing habits, it's not always clear how best to account for different streaming methods in profit agreements, Gatti said.

"It's somewhat like the Wild Wild West, because the business models are ever-changing depending on the technology and the different types of business plans, whether advertising-based or subscription-based," he said. "The way it gets accounted for is sort of changing as these business models change."

A viewer can now opt to watch a show on a laptop, video game console, tablet or mobile phone. Amazon.com Inc. offers streaming rentals, while subscription sites like Netflix Inc. and Hulu Inc.'s Hulu Plus provide unlimited streaming access. And faster Internet and Wi-Fi make it possible to view these shows virtually anytime, anywhere.

Currently, most profit-sharing agreements between studios and talent lump digital revenue into existing streams, depending on the product, said Jody Simon, an entertainment partner at Fox Rothschild LLP. Rarely are digital revenues allocated as a separate category.

In one agreement, for example, a show streamed on Netflix could be considered a TV product and subject to those distribution sales and costs. In another, it could be assigned to the home entertainment category, like DVD and VHS, and accounted for that way.

Issues come up, however, when participants argue that older formulas for distribution costs shouldn't be applied to digital, Gatti said. There are different costs involved with, say, streaming a show via the Internet than there are with shipping a DVD. " It does raise some issues and disputes as to how to account for profits," he said.

Negotiations so far are largely playing out in contracts, not the courtroom, Simon said, because digital deals haven't been making enough money up to this point to warrant litigation. That may change as the deals become more significant, Gatti added.

With ambiguity about the best way to classify digital revenue, studio and entertainment attorneys are trying to stay one step ahead of digital deals to maximize client profits, Berlinski said.

"To really understand whether participants have received a fair share, you have to understand the deals themselves," he said. But that's still a tall order. "People are still trying to figure out how these deals work because they are new and they are evolving at a very rapid rate."

One way profit agreements have dealt with categorizing digital revenues is by looking at how the product is used by the consumer, Gatti said.

The argument goes that if you can download a show and own it forever, it should be treated similarly to other purchased items a consumer owns, such as videotapes or DVDs. But if it's a download that only permits access for a limited time, it should be regarded as a rental, Gatti said. "Some people use the theory of, ' How is the end-user using it?' and therefore that's how it will be accounted for."

The ideal scenario for talent, Simon said, would be to "uncross" digital from other revenue streams and designate it separately — but that has yet to become a widespread practice across the industry.

He said such accounting may become more routine as digital continues to grow and account for a larger piece of the revenue pie.

But so far, entertainment attorneys have been left trying to make sense of the new environment.

"As [technology] evolves and the models solidify, participants' attorneys are going to get more sensitized to the issues," Simon said. "But I don't know how it's going to shake out."