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BY STANTON L. STEIN AND MARCIA J. HARRIS

## Repeal of the Fin-Syn Rules and vertical integration led to a barrage of lawsuits by profit participants in television projects

# VERTICALLY CHALLENGED

entertainment LAW special issue

VERTICALLY INTEGRATED media conglomerates have provided fertile ground for litigation in the entertainment industry due to self-dealing and at least the appearance of impropriety that inevitably arises when affiliated entities sit across from each other at the bargaining table. Vertical integration in the entertainment industry is a corporate strategy that involves the retention of control over all aspects of a motion picture, television program, or musical recording—from its creation through production and distribution. For example, with a television program, one vertically integrated conglomerate creates and produces the program, broadcasts the program on its affiliated network, and then licenses the syndication of the program to its own cable network and/or local television stations. To date, litigation alleging vertical integration claims primarily has focused on television programming rather than motion pictures or musical recordings.

Vertical integration accomplishes two goals for a conglomerate. First, the conglomerate achieves the complete control of an entertainment property, including the ancillary rights. Vertical integration allows the conglomerate to "brand" a property and keep it out of the hands of competitors. Second, vertical integration allows the conglomerate to dictate the financial terms of distribution and syndication because it controls both the licensor and the licensee of the rights in the property. In this way, the parent corporation of both the affiliated licensor and licensee can manipulate their negotiations to best serve the corporation's interest.

Vertical integration often has led to decreased license fees. A corporate conglomerate that produces a program through one of its production entities can ensure that its affiliated cable and television networks and television stations pay below-market license fees for the right to distribute the program. The strategy pursued by a conglomerate is simple. A smaller license fee results in less gross revenues from the distribution of the program. Distribution proceeds are often shared with the program's profit participants, such as actors, directors, writers, and producers, for whom participation in distribution profits is an integral component of their compensation.

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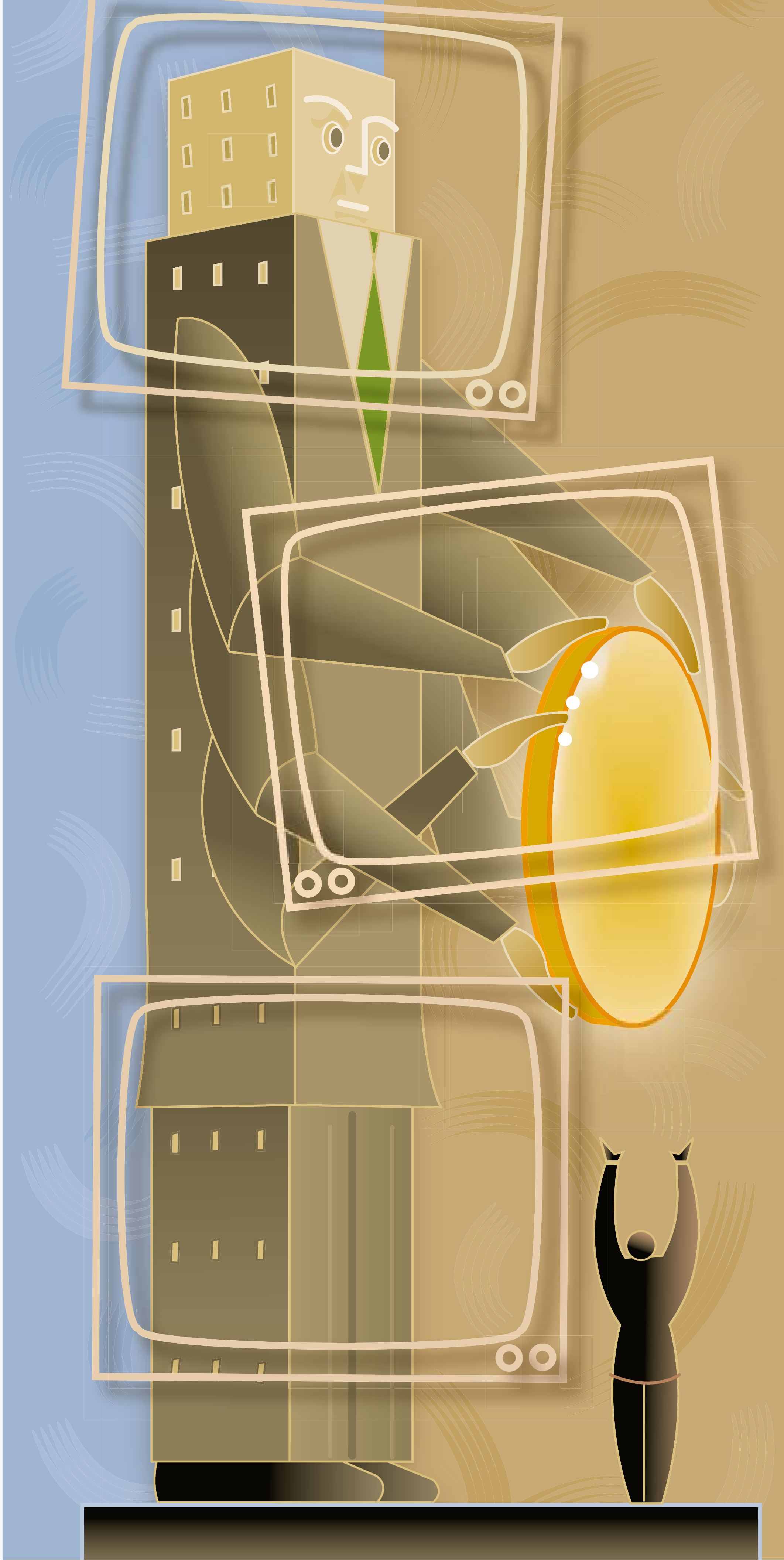
With this vertical integration strategy, profits that would have flowed to the profit participants instead remain within the corporate conglomerate because the affiliated licensees, such as cable networks, do not share their revenue with third parties. In 1998, Alan Alda sued Twentieth Century Fox Film Corporation for this practice and sought in excess of $10 million in lost profit participation revenue.[1]

The corporate strategy of vertical integration has been made possible by the merger mania in the late 1990s that resulted from the repeal of the "Fin-Syn Rules."[2] With the demise of the rules in 1995, the networks were no longer limited in their ability to produce or own an equity stake in the programs they broadcast. In anticipation of the repeal of the rules, the Walt Disney Company and Capital Cities/ABC announced a $19 billion merger on July 31, 1995, and Westinghouse announced its acquisition of CBS for $5.4 billion on August 1, 1995.[3] Subsequently, CBS merged with Viacom, creating a $91 billion conglomerate. These mergers and acquisitions were dwarfed by the merger of Time Warner with AOL, which was approved by the Federal Trade Commission on December 14, 2000, and, at $111 billion, is the largest merger in U.S. history.[4]

Today, all but one network, NBC, is owned by a media and motion picture studio conglomerate. ABC is owned by the Walt Disney Company, CBS and UPN are owned by Viacom (which also owns Paramount Pictures Corporation), the WB is owned by AOL/Time Warner, and the Fox network is owned by News Corp., which also owns Twentieth Century Fox Film Corporation. The potential for self-dealing is enormous.

While profit participants view these mergers as opportunities for self-dealing by the conglomerates, the conglomerates instead apply the term "synergy" to the mergers. Comments by Michael Eisner, chairman and chief executive officer of the Walt Disney Company, regarding the merger of Disney and ABC, are revealing and perhaps reflect an unfortunate choice of words: "The synergies are under every rock we turn over. I am totally optimistic that one and one will add up to four here."[5]

Not everyone agrees that the synergy resulting from vertical integration is a good thing. Many critics, for example, have raised concerns about the dissemination of news as a result of the concentration of news organizations in a handful of media giants. In addition, questions have been raised about the commercial propriety of vertical integration. But the two issues that have attracted the most concern are 1) the networks' attempts to acquire ownership interests in programs they broadcast, and 2) the potential for self-



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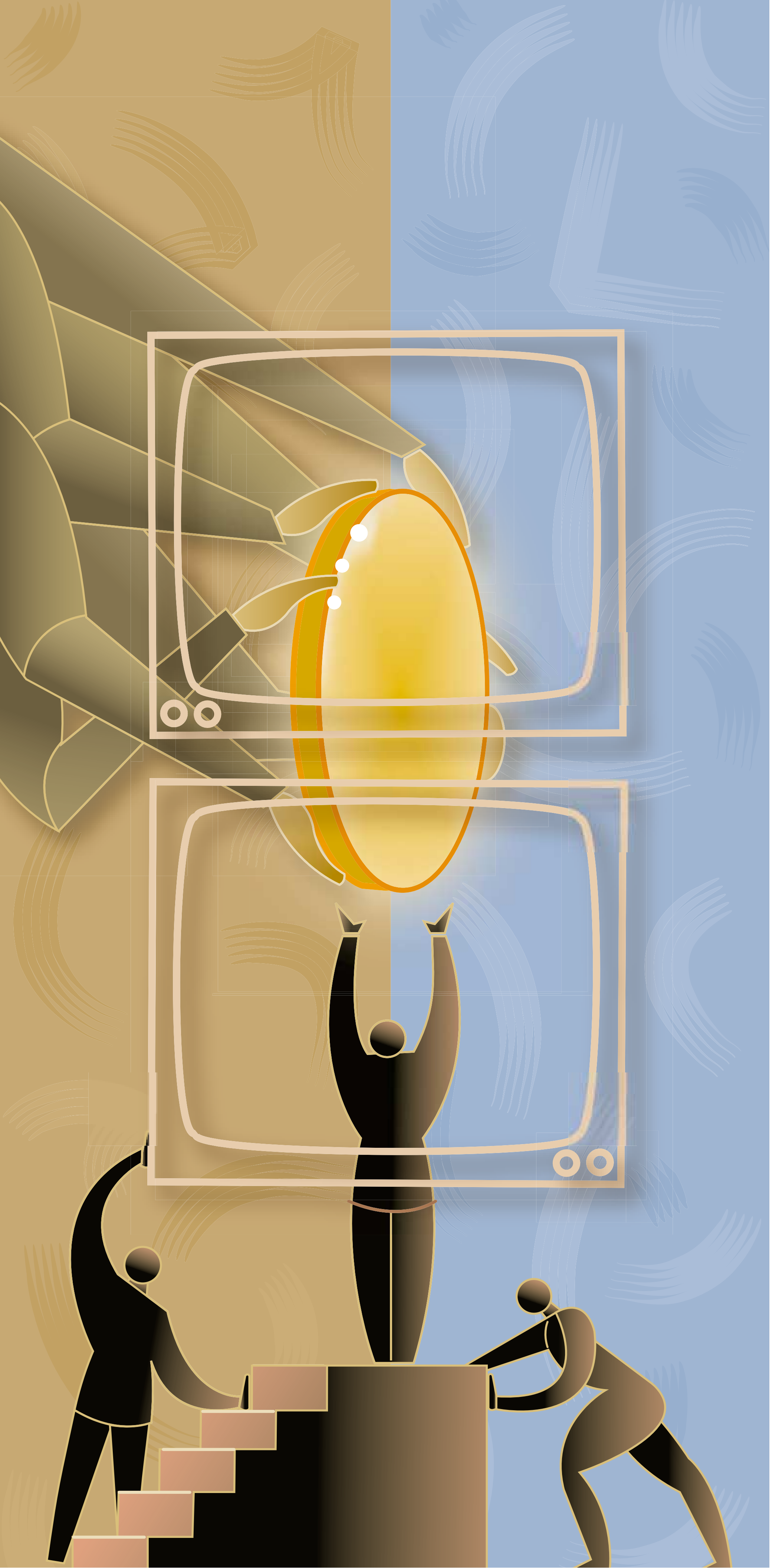

dealing among affiliated entities of the media conglomerates.

## SUING OVER SELF-DEALING

Concerns and questions about the self-dealing of media conglomerates to the detriment of profit participants have spawned a virtual cottage industry of lawsuits against the studios and networks. Among the lawsuits involving television programs that were filed starting in 1997 are:

- *Wind Dancer Production Group* v. *The Walt Disney Company*, which was filed in March 1997 with regard to *Home Improvement*.[6]
- *Mozark Productions* v. *MTM Enterprises*, which was filed in May 1997 and concerned *Evening Shade*.[7]
- Frank Lupo, Albert Ruddy, and Leslie Grief against CBS, a lawsuit that was also filed in May 1997 and was about *Walker, Texas Ranger*.[8]
- The Alda suit against Twentieth Century Fox Film Corporation, which was filed in February 1998 with regard to *M*A*S*H*.[9]
- David Duchovny's suit against Twentieth Century Fox Film Corporation, which was filed in August 1999 and involved the *X Files*.[10]
- Steven Bochco's action against Twentieth Century Fox Film Corporation, which was filed in September 1999 with regard to *NYPD Blue*.[11]
- Barry Levinson and Tom Fontana against NBC Studios, Inc., which was filed in March 2000 and concerned *Homicide: Life on the Street*.[12]
- *Langley Productions, Inc.* v. *Fox Entertainment Group*, which was filed in June 2000 and involved *Cops*.[13]

All of the cases were settled before trial—and for some, the settlement emerged on the very eve of trial.

The gravamen of these lawsuits is that the vertically integrated conglomerates engaged in self-dealing by artificially decreasing license fees and thereby injuring the program's profit participants. There is no incentive for a vertically integrated company to make any effort to shop its product among a variety of broadcast networks, cable networks, or other distribution channels in order to obtain the highest license fees for its programming. Rather, the incentive is for the affiliated entity owning the program to license it to another affiliated entity for a below-market price. That way, the affiliated licensee increases its profits (and the conglomerate's bottom line) while the revenues from the license fees that must be shared with the profit participant are reduced.

Although vertically integrated companies may argue that justifiable business reasons exist for vertical transactions, the practical effect cannot be disputed: reduced revenues available to profit participants and increased profits to the corporate parent's bottom line.

While some of the contracts between the profit participants and the owners of the television programs contain language designed to protect against disadvantageous self-dealing, many of the contracts that preceded the repeal of the Fin-Syn Rules do not. Two of the earlier lawsuits involving vertical integration are illustrative.

In the lawsuit initiated by Wind Dancer Production Group, creators of the television series *Home Improvement*, against the Walt Disney Company, the contract at issue had no protective language.[14] In fact, the contract provided only a right of consultation with regard to the distribution of the series. Thus, there was no contractual provision on which to hang a self-dealing claim.

In contrast, in the lawsuit filed by Alan Alda against Twentieth Century Fox Film Corporation, the self-dealing breach of contract claim was based on language contained in a 1991 Settlement Agreement[15] regarding Alda's audit of the *M*A*S*H* series profit participation statements.[16] A farsighted transactional attorney for Alda had inserted the following language into the agreement:

> If and to the extent Fox makes agreements in respect of exploitation of [*M*A*S*H*] with any affiliated entity which is a so-called "end user" such as, by way of example only, [Fox Broadcasting Company] or the Fox television stations, the income of such end user shall not be deemed gross receipts hereunder, but *Fox shall establish fair, just and equitable market rates, arms-length prices in such dealings, which shall be created on a reasonable and empirically justifiable basis*.[17]

When the contracts between the profit participants and television program owners contained protective language, the lawsuits alleged claims for breach of contract and inducing breach of contract (on the part of the parent company) as well as breach of fiduciary duty, unfair competition, interference with contract, and interference with prospective economic advantage.[18] Without the protective language, the lawsuits have relied on claims for breach of fiduciary duty, unfair competition, interference with prospective business advantage, and breach of the implied covenant of good faith and fair dealing. All of the lawsuits have sought an accounting.

### BREACH OF FIDUCIARY DUTY

The claims for breach of fiduciary duty in the vertical integration cases have been hotly contested. Essentially, the conglomerates argued that the profit participants have attempted to transform breach of contract claims into tort claims. In addition, the conglomerates argued that no fiduciary duty exists between a program's producer and its profit participant. In some instances, trial courts dismissed these claims on demurrer;[19] in other instances the claims survived demurrer and motions for summary adjudication.[20]

In defending against demurrers by the studios, the profit participants relied on a number of cases upholding a fiduciary duty to account to profit participants. For example, in *Braden* v. *Lewis*,[21] the court held, "[W]here property is transferred to another and an interest is reserved in profits which may be realized from the sale or operation of the property, a fiduciary relationship is created and the transferee is bound to account to the party from whom the property was received for the amount of the profits."[22]

Profit participants also relied on *Vai* v. *Bank of America*,[23] which held that "[t]he key factor in the existence of a fiduciary relationship lies in control by a person over the property of another."[24]

Indeed, two California cases specifically recognize a fiduciary duty owed to profit participants in the context of film distribution agreements. First, in *Waverly Productions, Inc.* v. *RKO General, Inc.*,[25] the plaintiff, a producer of two films, entered into a distribution agreement with the defendant in which the plaintiff retained profit participations in revenues from the distribution of the films. The court of appeal held that the plaintiff had not established a general fiduciary relationship between itself and the defendant, but the court noted that a limited fiduciary relationship existed with regard to the defendant's obligation "to account for rentals received" to the plaintiff.[26]

More recently, in *Recorded Picture Co. (Productions) Ltd.* v. *Nelson Entertainment, Inc.*,[27] the appellate court again reaffirmed the existence of the fiduciary duty recognized in *Waverly*. In *Recorded Picture*, the plaintiff, a film producer, entered into a distribution agreement with Hemdale, a distributor of motion pictures. Hemdale, in turn, entered into a separate subdistribution agreement with the defendant concerning home video rights. The court, relying on *Waverly*, noted that there was no fiduciary relationship between the plaintiff and the defendant because the defendant had no accounting or other obligations to the plaintiff. There was no privity of contract between the plaintiff and the defendant giving rise to an obligation to account for profits. Nevertheless, the court stated that "[a] fiduciary duty to the producer to provide an accounting of proceeds received did govern the relationship between [the plaintiff] and Hemdale" because there was contractual privity.[28] The court cited *Waverly* with approval and recognized that when a direct contractual relationship exists, "the distributor owed a fiduciary duty…to provide an accounting of proceeds received from subdistributors."[29]

A federal district court in New York also found a fiduciary relationship between contracting parties. In *Rosary-Take One Production Company* v. *New Line Distribution, Inc.*,[30] the court held that "it is possible, as a matter of law, for a fiduciary relationship to develop between contracting parties."[31]

Predictably, the conglomerates have rejected any notion that a fiduciary relationship exists with respect to profit participants. On demurrer, the conglomerates have attacked the breach of fiduciary claims by relying on *Zumbrun* v. *University of Southern California*[32] and *Peterson Development Company* v. *Torrey Pines Bank*[33] for the proposition that courts have cautioned against finding "loose characterizations" of financial relationships as fiduciary in nature.

In addition, the conglomerates, such as Fox in the *Duchovny*, *Bochco*, and *Langley Production* lawsuits, relied primarily on an unpublished federal district court order, *Crest Enterprises, N.V.* v. *Columbia Pictures Industries Inc.*,[34] for the proposition that a profit participant's audit rights somehow defeat a conglomerate's fiduciary duty to account for those profits. In the *Duchovny* and *Langley* actions, Fox's demurrers were defeated.

This year, in *Wolf* v. *Superior Court*,[35] the court denied a writ of mandate sought by the plaintiff, Gary K. Wolf, the author of the novel *Who Censored Roger Rabbit?*, which was turned into a movie by Walt Disney Pictures and Television. Wolf sought the writ of mandate to compel the trial court to vacate its order sustaining, without leave to amend, the demurrer of the real party in interest, Disney, to Wolf's cause of action for breach of fiduciary duty. The court held that a contingent entitlement to future compensation within the exclusive control of one party does not make that party a fiduciary in the absence of other indicia of a confidential relationship. The court stated that without an allegation of an agency relationship or a joint venture or a relationship "akin" to a joint enterprise, the right to a contingent entitlement would not support a claim for breach of fiduciary duty.[36] Since the decision was based on a writ of mandate during the pleading stage, it is likely that the decision will be appealed by Wolf or challenged by other participants in other cases.

To date, none of the cases alleging self-dealing claims have proceeded to trial. Instead, the conglomerates have paid substantial money to profit participants to resolve the claims before trial. In each of the cases, the studios have insisted on confidentiality provisions that prevent the disclosure of the settlement amounts.

### PROPHYLACTIC PROVISIONS

As a prophylactic measure, some of the studios now have amended their contractual provisions concerning profit participation. First, the words "net profits" and "gross receipts" have virtually disappeared from their contractual definitions of profit participation. Instead, the terms "defined proceeds," "contingent proceeds," "defined receipts," and "contingent bonus" now populate the definitions.

Moreover, the provisions now mandate binding arbitration to resolve any disputes concerning the definitions, whether sounding in contract or tort. Thus, discovery may be limited or nonexistent, depending upon whether an arbitration provision incorporates Code of Civil Procedure Section 1283.05.[37] More important, the profit participant has no right to a jury—a right that may be extremely valuable when a lone plaintiff takes on a behemoth media conglomerate.

In addition to arbitration provisions, many of the new back-end provisions contain presumptions in favor of the studio. For example, the profit participant must acknowledge that any dealing between the conglomerate's affiliated entities is "conclusively presumed to be fair, reasonable, and unobjectionable" unless the participant can establish that the "agreement or other arrangement is on financial terms which, taken as a whole, are materially less favorable economically" than a transaction between unaffiliated entities. For example, Disney's Exhibit "CB" (contingent bonus) provides:

> In addition, Lender acknowledges and agrees that any agreement or other arrangement by [Walt Disney Pictures] with an Affiliate or Related Party regarding the Exploitation Rights shall be conclusively presumed to be fair, reasonable and unobjectionable unless Lender shall establish that such agreement or other arrangement is on financial terms which, taken as a whole, are materially less favorable economically to [Walt Disney Pictures] than the terms of Similar Transactions generally entered into by [Walt Disney Pictures] with unaffiliated or unrelated third parties….

Even if the participant can meet this test, the participant's damages are limited only to what the participant would have received but for the unfair affiliated transaction—that is, no punitive damages or other remedies.[38]

According to agents and transactional entertainment lawyers, the studios are unwilling to negotiate many, if any, modifications to the arbitration provisions or any new provisions benefiting participants, regardless of the stature of their clients. Thus, as these provisions proliferate in contracts between participants and the conglomerates, the number of vertical integration cases may decline. Indeed, challenging the enforceability of these provisions may constitute the next wave of entertainment litigation.

In a recent case, *Pardee Construction Company* v. *Superior Court*,[39] the court held that a provision that required a judicial reference instead of a right to a jury trial and prohibited punitive damages was unconscionable and contrary to statutory law and public policy. In its holding, the court cautioned: "Our analysis is narrowly tailored to this record, in particular to the parties' agreements. We do not decide any issue as a matter of law. Instead, on this record we simply conclude the parties' agreements were adhesive contracts fatally infected with procedural and substantive unconscionability."[40]

Whether such a conclusion would be applied to the new back-end provisions imposed by media conglomerates is unclear. Certainly, agreements to arbitrate are looked on with favor in California. Many entertainment contracts contain arbitration provisions, and it is unlikely that courts will hold that a contract with high-level talent is unconscionable based on the perception that high-level talent has sufficient bargaining power. With respect to provisions that deny the right to punitive damages and shift the burden of proof, the outcome also is not certain.

There is no definitive authority on whether contractual provisions that prospectively waive punitive damages or shift the burden of proof are enforceable. Although *Pardee Construction Company* found a similar provision to be unconscionable,[41] the opinion should be read with caution because the court expressly limited its holding to the facts of that case, and the plaintiffs were homeowners with far less power to bargain the terms of a contract.

Thus, the enforceability of these new provisions remains in doubt, but one thing is certain: The media conglomerates will continue to self-deal. As Warren Buffett once said: "Negotiating with one's self seldom produces a barroom brawl."[42] Therefore, the disputes with profit participants will continue. Stay tuned. ■

[1] Alda v. Twentieth Century Fox Film Corp., L.A. Super. Ct. Case No. BC185779 (Feb. 1998).

[2] The Network Financial Interest and Syndication Rules, 47 C.F.R. §73.658(j) (1970). The Fin-Syn Rules were adopted in an effort to limit the power of the ABC, NBC, and CBS networks by prohibiting them from syndicating programs they had produced and from obtaining financial interests in programs produced by

outside producers that were broadcast by the networks. The Fin-Syn Rules were modified and amended in 1993 and repealed in 1995. 60 Fed. Reg. 48,907 (1995).
[3] Martin Peers and J. Max Robins, *CapCities Moves to Mouse House*, DAILY VARIETY, Aug. 1, 1995, at 1.
[4] *See* FTC Memorandum and Opinion (Dec. 14, 2000).
[5] LOS ANGELES TIMES, Aug. 6, 1995.
[6] Wind Dancer Prod. Group v. The Walt Disney Co., L.A. Super. Ct. Case No. BC 166377 (Mar. 1997).
[7] Mozark Prods., Inc. v. MTM Enters., Inc., L.A. Super. Ct. Case No. BC166980 (May 1997).
[8] Lupo v. CBS, L.A. Super. Ct. Case No. BC169347 (May 1997).
[9] Alda, L.A. Super. Ct. Case No. BC185779.
[10] Duchovny v. Fox Entm't Group, L.A. Super. Ct. Case No. SC058329 (Aug. 1999).
[11] Bochco v. Twentieth Century Fox Film Corp., L.A. Super. Ct. Case No. BC216801 (Sept. 1999).
[12] Levinson v. NBC Studios, Inc., L.A. Super. Ct. Case No. BC226456 (Mar. 2000).
[13] Langley Prods., Inc. v. Fox Entm't Group, L.A. Super. Ct. Case No. BC233041 (June 2000).
[14] The agreement between Wind Dancer and Disney was entered into in 1989, well before the repeal of the Fin-Syn Rules and prior to the acquisition of ABC by Disney. Wind Dancer Prod. Group v. The Walt Disney Co., L.A. Super. Ct. Case No. BC166377 (Mar. 1997).
[15] Alda v. Twentieth Century Fox Film Corp, L.A. Super. Ct. Case No BC185779 (Feb. 1998).
[16] The original *M*A*S*H* agreement for Alda's acting services was entered into in 1971. *Id.*
[17] Alda, L.A. Super. Ct. Case No. BC185779 (emphasis added).
[18] Both David Duchovny's contract and Langley Productions' contracts with Fox Entertainment Group, Inc. contained protective language similar to Alda's contract. Steven Bochco's contract with Fox had a right of consultation, but not the broader language—although, like Langley with *Cops,* Bochco retained the copyright in *NYPD Blue*, subject to Fox's distribution rights. *See* Duchovny v. Fox Entm't Group, L.A. Super. Ct. Case No. SC058329 (Aug. 1999); Langley, L.A. Super. Ct. Case No. BC233041; Alda, L.A. Super. Ct. Case No. BC185779; Bochco v. Twentieth Century Fox Film Corp., L.A. Super. Ct. Case No. BC216801 (Sept. 1999).
[19] *See, e.g.*, Wind Dancer, L.A. Super. Ct. Case No. BC166377.
[20] *See, e.g.*, Langley, L.A. Super. Ct. Case No. BC233041.
[21] Braden v. Lewis, 119 Cal. App. 2d 84 (1953).
[22] *Id.* at 87. *See also* Schaake v. Eagle Automatic Can Co., 135 Cal. 472, 485 (1902) (The plaintiff assigned patents to a corporation "but reserv[ed] an interest in certain profits which might be realized by the corporation" on those patents: "[T]he relation thus created was fiduciary and, as to plaintiff's share or part of the profits realized, the corporation was a trustee."); Stevens v. Marco, 147 Cal. App. 2d 357, 372-73 (1956) ("Where an inventor entrusts his secret idea or device to another under an arrangement whereby the other party agrees to develop, patent and commercially exploit the idea in return for royalties to be paid to the inventor, there arises a confidential or fiduciary relationship between the parties.").
[23] Vai v. Bank of Am., 56 Cal. 2d 329 (1961).
[24] *Id.* at 338. In *Vai*, the property settlement agreement between a husband and wife was rescinded by the court because the husband, who made fraudulent misrepresentations concerning the value of the community property, was a fiduciary to his wife on account of his knowledge and control over the property, which included cash.
[25] Waverly Prods., Inc. v. RKO Gen., Inc., 217 Cal. App. 2d 721 (1963).
[26] *Id.* at 733.
[27] Recorded Picture Co. (Prods.) Ltd. v. Nelson Entm't, Inc., 53 Cal. App. 4th 350 (1997).
[28] *Id.* at 371 n.10.
[29] *Id.*
[30] Rosary-Take One Prod. Co. v. New Line Distribution, Inc., 1996 U.S. Dist. LEXIS 1951 (S.D. N.Y. Feb. 22, 1996).
[31] *Id.* at *1 (citing Michelson v. Hamada, 29 Cal. App. 4th 1566, 1567 (1994)).
[32] Zumbrun v. University of S. Cal., 25 Cal. App. 3d 1, 13 (1972).
[33] Peterson Dev. Co. v. Torrey Pines Bank, 233 Cal. App. 3d 103 (1991).
[34] Crest Enters., N.V. v. Columbia Pictures Indus. Inc., CV 80-4777-MML (1981) (unpublished).
[35] Wolf v. Superior Court, 2003 Cal. App. LEXIS 270 (2d Dist., Mar. 20, 2003).
[36] *Id.* at 277.
[37] Subject to certain limitations, CODE CIV. PROC. §1283.05 provides for depositions and discovery to be obtained in an arbitration as if the subject matter of the arbitration were before a superior court in a civil action.
[38] Profit participation definitions have never permitted an award of attorney's fees to the prevailing party in any dispute relating to profit participations.
[39] Pardee Constr. Co. v. Superior Court, 100 Cal. App. 4th 1081 (2002).
[40] *Id.* at 1086.
[41] *Id.*
[42] WARREN BUFFETT ET AL., THE ESSAYS OF WARREN BUFFET: LESSONS FOR CORPORATE AMERICA (1st rev. ed., Apr. 2001)