Why Entertainment Royalty Audits Are Like a Box of Chocolates: Tips from the Experts

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Sponsored by the Licensing Division of the ABA Forum on Sports and Entertainment
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- 20+ years Entertainment industry experience
- Performed/supervised over 200 Entertainment royalty audits around the world
Faculty

David Halberstadter

• Partner & Deputy General Counsel, Katten Muchin Rosenman LLP
• 30+ years of Entertainment Litigation
• Represented motion picture studios and television production companies/networks in connection with 50+ audits and audit disputes
• Advised on and drafted dozens of contingent compensation definitions
Faculty

Steven D. Sills

- Partner, Green Hasson Janks
- CPA, Certified Fraud Examiner, Certified Financial Forensic, attorney
- 30 years of entertainment accounting experience
- Specializes in audits of motion pictures and television programs
Objectives

- Identify issues that arise in entertainment royalty audits
- Focus on the roles attorneys can and should play in connection with the drafting, administering and/or enforcing royalty-providing agreements
- Familiarize attorneys with how audits are initiated, conducted and resolved
- Share lessons learned from the speakers’ varied experiences
Webinar Agenda

• Types of agreements served by royalty audits
• Types of royalty audits/compliance investigations and how they are performed
• What auditors expect to do and see
• How attorneys can assist their clients
• Teachable moments
Entertainment Agreements Served By Royalty Audits

- Licenses to distribute trademarked merchandise
- Licenses to distribute copyrighted content
- Licenses to distribute broadcasted programming signals
Entertainment Agreements Served By Royalty Audits

• “Talent” profit participation agreements for motion pictures or television content
• Third-party equity/debt financing agreements
• Vendor-customer agreements for manufacturing and/or distribution of content media

1. THIS CONTRACT

By this Contract both parties associate themselves as business associates and not as partners, in the formation of a joint venture, for the purpose of engaging generally in the business provided for by terms and provisions of this Contract.

2. Definitions

1. The name of the joint venture will be referred to as the "Joint Venture" in this Contract.

2. The contract applies to all products in the attached schedule has granted the Joint Venture an exclusive right to maintain, enhance and sell these products, and to derive an income from the existing contracts associated with prior sales of said products.

3. Offices of the Joint Venture. The principal place of business of the Joint Venture shall be at headquarters, but may maintain such other offices as the Joint Venture may deem advisable at any other place or places.

4. Affiliate. An Affiliate of an entity is a person that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control of such entity.

5. Capital Contribution(s). The capital contribution to the Joint Venture actually made by the parties, including property, cash and any additional capital contributions made.

3. Purpose

1. The Joint Venture is formed for the purpose of engaging generally in the business of developing, owning and selling products and providing services associated with the ownership and management of such products. Without in any way limiting the generality of the foregoing, the business of the Joint Venture shall include: the development and sale of various versions of related products; Consultancy regarding manufacturing techniques;

2. Each Party recognizes that the others are willing and able to contribute capital, labour, and services for the operation of a successful joint venture business of a joint venture business operation does not, and is not intended to create a partnership, for either legal or taxation purposes. The Joint Venturers recognize that all of Parties are and will continue to be engaged in the conduct of the respective businesses for their own account.

The Parties also declare that they are not in any business other than that set forth in this Contract to be conducted within the Joint Venture. 
Royalty Audits: Why And How They Are Performed

• Why Are Royalty Audits Performed?
  – Increase proceeds to licensee
  – Manage oversight and collaboration
  – Investigate potentially adverse issues
  – Preparation for litigation
Royalty Audits: Why And How They Are Performed

• What Drives the Decision to Commence a Royalty Audit?
  – Cost of doing vs cost of not doing
  – Misperceptions of risk and reward
  – “Putting a stake in the ground”
Royalty Audits: Why And How They Are Performed

- How Royalty Audits Are Performed
  - Planning
  - Fieldwork
    - Commonly performed tests
    - Commonly identified findings
  - Follow-up
  - Reporting
Royalty Audits: Why And How They Are Performed

- How Royalty Audits Differ from Financial Statement Audits
  - Bases of accounting
  - Professional standards
  - Materiality concerns
  - Scope of activity tested
Royalty Audits: Why And How They Are Performed

• What Auditors Expect
  – Reasonable access to documents
  – Reasonable access to staff who can answer questions
  – Reconcilable audit trails
Royalty Audits: Why And How They Are Performed

• Risk Issues in Profit Participation Audits
  – Fiduciary duty claims
  – Co-ownership claims
Royalty Audits: Why And How They Are Performed

• Risk Issues in Profit Participation Audits
  – “Package” allocations
  – Foreign territory activity
  – Sub-distributor activity
Royalty Audits: Why And How They Are Performed

• Risk Issues in Profit Participation Audits
  – “Most favored nations” compliance
  – “Vertical integration”
How Attorneys Can Prepare Their Clients

• Drafting and negotiation of the contract
  – Royalty calculation provisions
  – “Scope of audit” provisions
  – Dispute resolution provisions
How Attorneys Can Prepare Their Clients

• Contract performance
  – General oversight of reporting obligations
  – Advising on specific interpretation issues
  – Assessing impact of new transactions or changes to business model
How Attorneys Can Prepare Their Clients

• Following an audit request
  – Ensuring compliance with audit provisions
  – Advising on contractual limitations to scope of audit
  – Monitoring compliance with confidentiality issues
  – Advising on auditor requests that exceed contract limitations
How Attorneys Can Prepare Their Clients

- After completion of audit
  - Review and analysis of audit claims and/or report
  - Risk assessment
  - Preparation for dispute resolution/litigation
How Attorneys Can Prepare Their Clients

- What attorneys should expect from auditors
  - Economically reasonable and contract-supported findings
  - Findings capable of recalculation
  - Findings supported by auditor’s workpapers
Significant Legal Issues

- The nature of the relationship between the company and the participant
- The potential impact of “incontestability” and other contractual limitation provisions
- Contractual limitations on the scope of document review
Anticipating Future Challenges

• How might the licensor/licensee relationship be impacted by:
  – New transactions
  – New Competition
  – Evolution in business model
Teachable Moments & Lessons Learned

• Auditors engaging in contract interpretation
• Audit claims based on conjecture and extrapolation
• Effective tax rates
• “Silent” contracts
• Application of home video historical standard to new media
Teachable Moments & Lessons Learned

- Contradictory audit claims based on same revenue or expense
- Impact of questionable claims on auditor credibility
- Refusal to compromise leading to larger, subsequent settlement (or judgment)
Wrap-Up & Questions