Profit Participation Practices Should Be Reviewed in Light of Recent *Ladd* Decision

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On May 25, 2010, the California Court of Appeal issued its decision in the ongoing dispute between Alan Ladd, Jr. and Warner Bros. Entertainment, Inc. with respect to the manner in which Mr. Ladd had been accounted to for films that Warner had licensed as part of various packages to broadcast television and cable networks. *Ladd v. Warner Bros. Entertainment, Inc.*, 2010 WL 2044878 (May 25, 2010). In light of the court's ruling, which has been certified for publication and therefore can be relied upon by other profit participants, motion picture studios and other distributors of entertainment content should review carefully their own package allocation practices and profit participation definitions and consider whether changes to either might be warranted.

Overview of the Appellate Decision

Mr. Ladd was a profit participant in numerous motion pictures distributed by Warner, including *Blade Runner*, *Body Heat*, *Night Shift*, *Chariots of Fire* and the *Police Academy* franchise. Warner licensed these motion pictures as part of various film packages to broadcast television and cable networks.

In a practice known as "straight-lining," Warner allocated the same share of the licensing fee to every movie in a package, even though for internal purposes, Warner had assigned each movie a grade of "A," "B" or "C." Warner acknowledged that there was no licensing demand for individual "C" titles, which were included in the film packages as "filler material."

The thrust of Mr. Ladd's claim was that by allocating the same portion of the licensing fee to every movie in a package without regard to the true value of each movie, Warner deprived Mr. Ladd of a fair allocation of the license fees to which Mr. Ladd was entitled as a profit participant.

The case was tried to a jury in July 2007. The jury returned a verdict in Mr. Ladd's favor, in which it found that Warner had breached its agreement with Mr. Ladd and/or the covenant of good faith and fair dealing implied by law in that agreement, and awarded Mr. Ladd in excess of $3 million in compensatory damages. Warner appealed.

The appellate court concluded that under the implied covenant of good faith and fair dealing, Warner was bound to act in good faith toward profit participants. Warner had an obligation to fairly and accurately allocate license fees to each of the films based on their comparative value as part of a package. It therefore held that the evidence supported the jury's determination that Warner's straight-lining method of allocating licensing fees to profit participants breached the implied covenant of good faith and fair dealing.

In reaching this conclusion, the appellate court observed that under California law, every contract contains an implied covenant of good faith and fair dealing, pursuant to which neither party may do anything that would injure the right of the other party to receive the benefits of the agreement. The implied covenant "finds particular application in situations where one party is invested with a discretionary power affecting the rights of another," the court noted.

It appears that the appellate court found particularly significant the trial testimony of Warner's own president of domestic cable distribution, Eric Frankel, who conceded that Warner owed its profit participants an obligation to act in good faith in the licensing process. Mr. Frankel testified that Warner was required to "fairly and accurately allocate

license fees to each of the films based on their comparative value as part of a package, taking into consideration such factors as "the vintage of the film, the box office, the genre, the star, the awards, the utility, can you play it in multiple day parts or is it a movie that's too sexy that maybe you can only play at 10:00 at night."

The court also found noteworthy the evidence that in instances where Warner did not use a straight-line allocation, higher allocations often were given to motion pictures that did not have profit participants (for example, a Daffy Duck animated film versus *Chariots of Fire*).

The Court of Appeal expressly rejected Warner's assertion that its buyers often insisted on paying the same license fee for every film they acquired, finding instead that, based upon the evidence presented at trial, most licensees only care about the aggregate amount of their license fee. It also considered without merit Warner's claim that straight-lining of films in a licensing package is indisputably a common practice in the industry, finding both that the prevalence of straight-lining was a disputed issue at trial and, even if it were a common practice, "it would not absolve Warner of its duty to Mr. Ladd, as a profit participant, to fairly allocate fees derived from licensing packages."

What Should Be Done?

In concluding that Warner's straight-line method of allocating license fees to motion pictures included in license packages constituted a breach of the implied covenant of good faith and fair dealing in its agreement with Mr. Ladd, the Court of Appeal *did not* find that the only allocation methodology that would satisfy the implied covenant would be a title-by-title evaluation of each film's unique qualities and track record. To the contrary, the court's ruling arguably suggests Warner might have satisfied its duty of good faith had it allocated the same, high license fee to each of the "A" titles in its packages, a significantly lower license fee to each of the "B" titles, and a token amount to each of the "C" titles.

It therefore would be worthwhile for any company that distributes motion pictures or other content in packages to review its own allocation practices. Allocating the same license fee to each title in a package should be avoided at all costs, unless the company can demonstrate persuasively that each title is of equivalent value. To the extent that the company places its titles into different "tiers," it should make sure that the factors used for such placements can be clearly articulated, rationally justifiable, and consistently applied. An even more conservative approach would be to adopt a formula —for example, a "points" system based upon the title's age, historic performance and other key factors—by which individual license fee allocations can be made for each title in a package.

It would also be beneficial for companies that have accounting obligations to profit participants to review the provisions of its profit participation definitions (if there are any) that address package distribution and/or the allocation of license fees. Consideration should be given as to whether the profit participation definition could be modified to give the company complete discretion with respect to package allocations, or at least restrict the extent to which a participant may challenge a package allocation and the scope of any such claim. As a matter of law, if a contract includes an express provision such as this, the implied covenant of good faith and fair dealing cannot be construed in a manner that contradicts or supplants the express contract rights.

A Final Word About Statute of Limitation Defenses

Many profit participation claims are subject to contractual limitation periods that either deem "incontestable" accounting statements to which formal, written objections are not timely made, or that require claims of incorrect accounting to be litigated within a specified period (which typically is shorter than the statutorily-prescribed period), or both.

In *Ladd*, Warner asserted that a portion of Mr. Ladd's accounting claims were time-barred, but it did not offer proof at trial as to the amount of the claim that supposedly fell outside the permissible time period. Following the jury's verdict, Warner requested that the trial court enter judgment in its favor notwithstanding the verdict on the basis, among others, that the verdict included damages on claims that were time-barred. The trial court denied this motion, and the Court of Appeal affirmed that decision.

The court held that because the statute of limitations is an affirmative defense, a defendant who asserts that the plaintiff's claims are partially barred by the statute of limitations has the burden of proving which portion of the plaintiff's damages are time-barred. The failure to do so results in a complete failure of the affirmative defense. Because Warner failed to present damage segregation evidence, Mr. Ladd was entitled to recover all of his proved damages.

If you have any questions about the implications of the *Ladd* decision for your business, please contact:

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