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## Profit Participation Mediation Tips From The 'Bones' Case

By **Bruce Isaacs** (March 21, 2019, 2:51 PM EDT)

The typical profit participation mediation begins with outrage, betrayal and mistrust. The profit participants claim that the distributor has been stealing money from them for years, while the distributor defends the contract.

Then, after some meaningful discussion of the key issues in dispute, the next event happens almost every time: both sides dig their heels in and immovable intransigence sets in. As expected, the profit participants' initial demands are through the roof, which are "nonstarters" from the distributor's point of view and, not surprisingly, the distributor's counter-offers are miles and miles away.

All of this leads to the first key question of the day: Is it time to go home yet?

The answer is no. Despite this inevitable rocky start that typifies almost every profit participation mediation, a settlement can be achieved if the parties continue to work through, and be realistic about, the key open issues.

So, what are the typical issues arising in a profit participation mediation? Why are the parties so far apart and how can the parties overcome these vast chasms? What are some of the lessons from the recent "Bones" arbitration decision that will invariably have an effect on profit participation mediations yet to come?

### The Most Common Open Issues

#### Contract Interpretation Issues

Often times, a basic reading of the contract answers some very big questions. In contrast, there are times when a provision is reasonably susceptible to more than one interpretation, and parol evidence, such as the key conversations of the parties or an expert's testimony on custom and practice, becomes crucial.

For example, the parties may be fighting over what distribution fee applies for a particular type of exploitation of the film or television show at issue. The contract may appear, at first blush, to answer the question, but given the rapid changes in technology and new media of exploitation, the answer may indeed be ambiguous, the intent of the parties may be hard to discern and the conflicting expert testimony only creates guaranteed uncertainty. On the other hand, the language of the contract may be indisputably clear on its face and the plain language does indeed answer the legal questions in dispute.

In the latter case, the mediation may be taking place too early. Perhaps a motion for summary adjudication (or summary disposition in an arbitration context) needs to be heard and determined, or at least pending, in order for the parties to be truly ready for (and committed to) a meaningful mediation.

However, does the adjudication of this one particular contract interpretation issue, even if it involves a substantial sum of money, fully dispose of a cause of action so that summary adjudication in a



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court proceeding is even appropriate? Does the approach of *Lilenthal & Fowler v. Superior Court*, where a party will argue that the particular audit claim at issue is sufficiently separate and distinct, provide a basis to dispose of that issue so as to remove a key impediment that is likely to derail the upcoming mediation, or not? In short, is a court adjudication necessary before the parties can get real about the other open audit claims?

A grant of such a motion for summary adjudication certainly creates leverage for the moving party — and motions for summary adjudication can be effective if filed by the distributor, which is often the case, but they may be equally effective when filed by the profit participants as well. Obviously, if a motion for summary adjudication is filed by the distributor and is denied, this creates an enormous benefit for the profit participants. Once the profit participant gets past a summary adjudication, and assuming the contractual provision at issue is reasonably susceptible to more than one interpretation, and assuming further that the parol evidence is in conflict, the leverage, of course, shifts to the profit participants.

Thus, timing is key. If the distributor believes at the mediation, rightly or wrongly, that it is going to prevail on the key question of contract interpretation as a matter of law, it may not be ready to participate in a meaningful mediation. In short, where it is (or should be) obvious to the attorneys for both sides that they are dealing with a relatively clear and unambiguous contractual provision (and one that is a big-ticket item in terms of money or value), then tee up, or get past, all necessary motions so that this particular “impediment audit issue” is taken out of the calculus before the mediation begins.

### Affiliated Transactions/ Self-Dealing

Because of the frequency of vertical integration lawsuits over the past several years, and given the undeniable trend toward business consolidation in the entertainment industry, it is common for contracts with profit participants to include an “affiliated transaction provision,” which requires the distributor, when entering into a transaction with a related or affiliated company, to do so on monetary terms comparable to deal it would enter into with an unrelated third party.

Because affiliated transaction provisions are prevalent (and may be imposed by operation of law in any event), it is extremely common for profit participants to argue that the distributor entered into a deal that is below market value, like a license fee that is well below what it would have paid to, or did pay to, an unrelated third party. The profit participants argue that this is a form of self-dealing, the effect of which is to reduce the back-end profit participation payable to the profit participants. And, as the profit participants' damages experts frequently argue, and demonstrate with their damages models, the financial impact of these affiliated transactions significantly reduces the amount of money due and owing to the profit participants.

As we all learned from the widely disseminated “Bones” arbitration decision, if the distributor has an obligation to enter into a license on monetary terms comparable to the terms it has paid to an unrelated third party, it had better do just that — go out and determine what it has paid to an unrelated third party on a comparable show, and then actually pay that amount for the license.

In *Wark Entertainment Inc. v. Twentieth Century Fox Film Corp.*, recently decided by the Los Angeles Superior Court, the arbitrator determined that Fox breached the affiliated transaction provision because (1) it never went out and determined what it had actually paid to unrelated third parties on comparable shows (it never asked for, received or reviewed this requisite information); and (2) it failed to pay comparable monetary terms. Moreover, the arbitrator found, based on his view of the evidence, that Fox never intended to honor the affiliated transaction provision in the first place.

Thus, if a contract contains an affiliated transaction provision and if there is evidence that the provision is not adhered to, or other evidence of self-dealing, it may create serious financial jeopardy for the distributor. Such an occurrence can lead to big numbers, and those big numbers may be amplified by the important issue of prejudgment interest that can greatly increase the amount in controversy.

As a way to address the potentially explosive issues that can arise from an affiliated transaction provision, the industry came up with a workaround: the imputed license fee provision by which the parties agree at the time of contracting to this provision and a formula on how to arrive at an

imputed license fee in the event of an affiliated transaction. But does this really solve the problem? Many times, a contract will have both an affiliated transaction provision and an imputed license fee provision. If so, which one prevails over the other?

To further complicate the situation, it is often the case that profit participants will also have a most favored nations provision in their contract. What happens if profit participant No. 1 with a most favored nations provision has both an affiliate transaction provision and an imputed license fee provision, but profit participant No. 2 has just an affiliate transaction provision? Is participant No. 1 upgraded to the benefits of the affiliated transaction provision and thus able to avoid the detriments of the imputed license fee provision by virtue of the most favored nations provision?

Obviously, there are no clear answers to these dicey questions, but the risks of an affiliated transactions provision are apparent as the recent "Bones" arbitration decision so demonstrates, and the imputed license fee provision may, or may not, mitigate the potential sting.

### Subscription Video-on-Demand Under Old Contracts

This issue is getting worked out as entertainment transactional attorneys negotiate new deals with a new set of distributors who have a different kind of business model (which includes a buy-out of the back-end profit participation). More traditional contracts often give rise to a dispute as to whether gross receipts from subscription video-on-demand, or SVOD, which have grown considerably in recent years, should be thrown into the overall pot in which the profit participants share at 20 percent (treated as home video) or at 100 percent (not treated as home video).

And how are gross receipts from SVOD to be allocated? It is not easy to determine which films in a subscription service generate the most views and are thus arguably deserving of the favorable allocation of the income stream when such data is not readily available as of yet (or solely within the possession of the subscription service).

For allocation issues generally, see the "Blade Runner" case, *Ladd v. Warner Bros.*, in which the court rejected a straight line allocation approach because it did not take into account the relative value of the films which were responsible for generating the gross receipts.

These are critical questions for which there are no clear answers. Thus, it is a perfect issue for compromise or horse-trading.

### Prejudgment Interest

Not surprisingly, disputes over which distribution fee should apply or disputes over affiliated transactions often involve large sums of money. For example, assuming an eight-figure dispute, and assuming a claim for prejudgment interest, all of a sudden the amount in controversy increases dramatically (especially if the disputes and the audit process have been ongoing for a number of years). Thus, the fight over prejudgment interest has significant monetary consequences.

Some contracts include a provision providing that the right to recover interest is waived during the pendency of the audit process the accounting disputes. Does such an interest waiver provision prevail over California Civil Code Section 3287(a), the statute which entitles the judge or the arbitrator to award prejudgment interest when the damages are in a certain amount or capable of being made certain by calculation? Does such an interest waiver provision prevail over California Civil Code Section 3289(b), the statute which entitles the judge or the arbitrator to award prejudgment interest based on his or her discretion, but interest may not be awarded earlier than the date on which the claim was filed? Perhaps so, perhaps not.

In the "Bones" arbitration decision, the arbitrator found that the ultimate damages award was not capable of being made certain and he did not award prejudgment interest on that basis. But the arbitrator did determine, in his discretion, that prejudgment interest was appropriate, though only from the Jan. 11, 2016, filing date, which still resulted in an additional \$10 million of damages in prejudgment interest alone.

At the profit participation mediation, other issues involving prejudgment often arise. When does prejudgment interest begin to run? If an audit is commenced in early 2005 and an action or

proceeding is filed in late 2005, and a new audit claim is asserted in 2010, would the prejudgment interest (assuming it's appropriate) run from 2005 or 2010?

It would certainly be reasonable for a distributor to argue that it should not be obligated to pay for prejudgment interest running from 2005 when the claim was not even made until 2010. On the other hand, the profit participants could reasonably argue that the alleged improper charge dates back to 2005 regardless of when it was asserted and, because it is a certain amount, prejudgment interest should run from that earlier date.

Often times, the profit participants will argue that if the improper charge had been reversed years before, not only should they receive prejudgment interest on that amount, but, in addition, they have lost the use of the money for many years and therefore have been further damaged because they lost the time-value of that money (for which they seek to be reimbursed).

In short, prejudgment interest often involves large sums of money, so it becomes an important issue over which the various sides do battle.

### Incontestability

Every distributor has an incontestability provision in its contract, a provision which provides that if the profit participant does not object to the participation statement in a certain amount of time (typically two years), and does not do so in sufficient detail, then the participation statement becomes incontestable, conclusive and binding.

In *Wind Dancer Production Group v. Walt Disney Pictures Inc.*, the profit participants first challenged the incontestability provision itself and argued that based on various facts (only one audit per 12-month period; having to wait in the audit queue; unable to commence the audit until Disney so permitted; a 1.5- and 4-year wait for the audit; the audit had to be completed within 60 days of commencement), Disney was estopped to assert the incontestability provision and, therefore, a prior grant of summary judgment by the trial court had to be reversed.

The appellate court embraced the estoppel argument and ruled that the trial court should not have granted the motion for summary judgment, but the court also upheld the validity of the incontestability provision, a significant victory for distributors. The incontestability provision thus provides a strong and now court-approved defense for distributors.

### Closing the Gap

The opening offers for both sides are unsurprisingly on opposite sides of the charts and progress is slow, if made at all. But mediators will talk through the issues, the various merits of the claims and provide an evaluation of the issues so the parties can advise their clients about their upside and downside. Sometimes, the parties are not ready for a meaningful mediation because there are unresolved contract interpretation issues, key documents have not yet been produced or crucial depositions have not been taken. In the latter instance, the mediator needs to set a protocol to work out an exchange of critical information and testimony so the parties can better understand and evaluate their respective cases.

If, however, the timing of the mediation is right, the mediator will dig into the issues, the testimony, the language of the contracts and the damages models and discuss these issues with the parties and do its best to make progress. The mediator will make use of its tool box, provide a realistic evaluation of the audit claims, point out the pros, cons and risks, and utilize traditional negotiations, double blind brackets or a mediator's proposal if necessary.

### Conclusion

Don't walk out. Work through the issues. Be objective. Be realistic on how you read the contracts. File motions to get rid of matters of pure contract interpretation ahead of time, if need be. Exchange information. If you are right on an issue, show it. Give the documents which prove you are correct. Attend a mediation at the right time. Bring your experts with you to the mediation. Recognize that your highly aggressive offers will be matched in kind in the other room and impasse and stagnation will result. Decide if you really want to settle your case, or not. And, if not, and given "Bones," make

sure your clients fully understand the risks of how a jury, or even an arbitrator, will react to your particular factual pattern and issues.

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