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Internet Killed the Video Star: How In-House Internet Distribution Will Affect Profit Participants

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ARTICLE

Internet Killed the Video Star: How In-House Internet Distribution of Home Video Will Affect Profit Participants*

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* The title alludes to a song by the Buggles, *Video Killed the Radio Star*, *on* THE AGE OF PLASTIC (Island Records 1979), which became popular after it was the first video played on Music Television [MTV] on January 1, 1981. MTV was the brainchild of Warner Communications and American Express. *See The Buggles: Video Killed the Radio Star*, The Octopus's Garden, *at* http://www.rareexception.com/Garden/Eighties/Video/buggles.php (last modified Feb. 15, 2002); George Petersen, *The Smartest Bet in Town*, *at* http://mixonline.com/ar/audio_editor_3 (Apr. 1, 2001). MTV threatened to change the way the world perceived musical artists by focusing on the artists' look and performance, rather than vocal talent. The current popularity of Britney Spears, 'NSync, Ricky Martin, and their sundry knockoffs indicates, at least to this author, that the prophecy was not entirely apocryphal.

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INTRODUCTION

In 2001, there were 149 million Internet users in the United States and 544 million worldwide.[1] This number is projected to increase to 186 million and 945 million, respectively, by 2004; and 230 million and 1.47 billion, respectively, by 2007.[2]

Since only 9.5 million homes have high-speed Internet access, it can be inferred that the majority of these users are operating, at a maximum, with 56k modems.[3] Without broadband, [4] it takes

[1] *See Internet User Forecast by Country* tbl. 1.4, *at* http://www.eTForecasts.com/products/ES_intusersv2.htm (last modified Dec. 7, 2002).

[2] *See id.* tbl. 1.1 (demonstrating an average increase of about twenty percent per year worldwide).

[3] *See* Pamela McClintock, *Valenti Sees 'Peril' in U.S. Copyright Fight*, DAILY VARIETY, Mar. 4, 2002, at A9 (noting that Jack Valenti, President and CEO of the Motion Picture Association of America [MPAA], estimates that only 9.5 million homes have high-speed Internet access).

[4] Broadband is defined by the U.S. Federal Communications Commission [FCC] as a service that offers more than 200 kbps in any one direction. *See* F.C.C., INQUIRY

between twelve and fourteen hours to download a full-length feature film, so at the present time it is not entirely feasible for the majority of users to rent films over the Internet.[5] With broadband, however, it takes as little as twenty-five to thirty minutes; in the future this figure should decrease to a mere forty-five seconds.[6] Additionally, Qualcomm is developing the technology and establishing a uniform standard to link computers to television sets so that consumers will be able to watch downloaded videos on their home theater systems instead of their computer monitors.[7] In only a few years, most netizens[8] will be renting videos over the Internet to watch on big screen TV.

But who will provide the service? How much will they charge? And, most importantly for the film industry, how will the revenues be determined for profit participants? These are some of the most critical questions facing today's entertainment attorney, and their resolution surely will be the subject of hotly contested litigation in the not-too-distant future.

Part I of this Article defines profit participation and argues that in-house Internet home video distribution will deprive writers, directors, producers, and actors (hereinafter cumulatively "Talent") of their earnings because studios surely will use biased reporting procedures. Part II examines the basis for this bias by discussing how studio in-house Internet home video distribution may eliminate the independent reporting procedures of content aggregators. This section compares the efficiency and desirability of traditional distribution models to the new Internet model, and argues that although there is a reasoned economic need for such

CONCERNING THE DEPLOYMENT OF ADVANCED COMMUNICATIONS CAPABILITY TO ALL AMERICANS IN A REASONABLE AND TIMELY FASHION, AND POSSIBLE STEPS TO ACCELERATE SUCH DEPLOYMENT PURSUANT TO SECTION 706 OF THE TELECOMMUNICATIONS ACT OF 1996, THIRD REPORT 7–8 (2002), http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-02-33A1.pdf.

5 *See* McClintock, *supra* note 3.

6 *See id*.

7 Gary Garland, Address at the 26th UCLA Entertainment Law Symposium (Jan. 25, 2002).

8 People who use the Internet. *See Netizen*, Netlingo *at* http://www.netlingo.com/right.cfm?term=netizen (Netizen: "A citizen of the Internet, as in, one who spends a significant amount of time online or is an experienced user of the Net.").

distribution, it will be prejudicial to profit participants who should protect themselves through the following alternatives: independent auditing, litigation, or collective bargaining that mandates arbitration. Additionally, the government must vigorously enforce antitrust law, because the recent trend of vertical integration by large media companies has deprived profit participants of meaningful negotiating power and the ability to collect their contractual earnings. Part III further discusses the antitrust implications of this new video distribution model and argues that in-house studio distribution of home video will be anathema to the sound public policy of protecting weaker bargaining parties and ensuring that contracting parties receive the benefit of their bargain. Part IV discusses how Internet distribution threatens both studios and profit participants by making videos vulnerable to widespread piracy, with the resulting losses surely passed on to profit participants. This Article concludes that fundamental change is necessary in order to protect profit participants from the potential abuse that in-house Internet distribution of home video presents to film studios.

I. TALENT PARTICIPATIONS DEFINED

In the entertainment industry, Talent creates works for hire that a studio owns, and for which "they are paid fixed and contingent compensation."[9] The principal form of contingent compensation is the profit participation provision.

The modern version of the profit participation began in 1950, when Hollywood went from a "studio system" of weekly player contracts, or per-picture salaries, to percentages of so-called "profit" pools.[10] At that time, Jimmy Stewart agreed to forego his fixed compensation for *Winchester '73,* in exchange for a "back-end" (after the film is released) profit participation of fifty percent of the net profits resulting from the studio's exploitation of the film. Unfortunately, the film was not a commercial success and

9 BILL DANIELS ET AL., MOVIE MONEY 211 (1998).
10 *Id.* at 202 (quoting Mel Sattler, former head of Universal Studios's business affairs department).

Mr. Stewart received no money for his work.[11] Initially, then, the earliest form of a profit participation was a venture in which Talent alone shouldered the risk when the film failed, but was well-rewarded when it succeeded.

Since that time, profit participation has evolved into a sum granted *in addition to fixed compensation.* Therefore, studios now bear more of the risk, because they must pay the fixed compensation even if a film fails, *and* they must share their profits if the film succeeds. Talent, however, still bears some risk because Talent will often accept a lower fixed salary up-front for a larger slice of the profits on the back-end. Consequently, figures such as Mr. Stewart's fifty percent profit participation share no longer exist. The norm for current profit sharing provisions varies between one and fifteen percent depending upon the Talent's ability to draw an audience.[12]

This mutual risk arrangement is designed to produce mutual reward, but does it? In the film industry, modern profit participation provisions are formulaic and often attached to agreements as the studio's Exhibit "A." Although the terms are boilerplate, or standard, the provisions are actually creatures of contract. Typically, parties exercising independent will and free choice *negotiate* contractual provisions; however, this is not the case in an industry where only seven key players control the purse strings.[13] In such a restrictive environment, contractual provisions are rarely, if ever, negotiated, and any alterations will result from the Talent's relative bargaining strength.[14]

Nevertheless, profit participations are highly desirable because they confer bragging rights upon the Talent who receive them, enabling them to reap future windfalls that can be worth millions if

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11 *See id.* at 202–203.

12 *See id.* at 204. Ironically, profit participations only go to the most powerful Talent, usually the top five percent of all working actors; however, one definition of a net participant is one who "wishes they had more leverage." *See id.* at 297.

13 The seven major studios are Metro-Goldwyn-Mayer Inc., Paramount Pictures Corporation, Sony Pictures Entertainment, Inc., Twentieth Century Fox Film Corporation, and Universal Studios Inc., Walt Disney Company, and Warner Brothers. *See* MPAA, *at* http://www.mpaa.org/about/index.htm (last visited Feb. 19, 2003).

14 *See* DANIELS ET AL., *supra* note 9, at 208, 211–12, 226.

the motion picture becomes a commercial success.[15] Since Talent wants profit participation, and entertainment attorneys spend endless hours agonizing over how profit participation is defined, it is necessary for an entertainment attorney to have a proper understanding of the terms and drafting. Here are a few of the fundamentals.

A. Net Profits: The Big Picture

Talent participation is based on net profits. Net profits are not mandated by statute, as are tax calculations,[16] or agreed upon by the guilds, as are residuals.[17] Net profits, like Talent participations, are creatures of contract.[18] There are essentially four definitions of studio net profits: (1) Generally Accepted Accounting Principles (GAAP), for reporting earnings to the SEC, shareholders, and lenders; (2) calculating income and loss for tax reporting to the Internal Revenue Service; (3) calculating cash available for distribution to equity holders of the film company, and (4) calculating payments to profit participants.[19] In their simplest form, each accounting method essentially boils down to the following model: gross revenues – (distribution fees + distribution expenses + negative cost) = net profits.[20]

B. Net Profits: Breakout

1. Gross Revenues

Gross revenues are all revenues received from a film in all media, minus off-the-top expenses such as (1) conversion costs,[21]

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[15] *See id.* at 210–11, 249.

[16] *See* SCHUYLER M. MOORE, THE BIZ 120 (2000).

[17] *See, e.g.*, WRITERS GUILD OF AM., THEATRICAL AND TELEVISION BASIC AGREEMENT art. 65, at 350–96 (1998).

[18] *See* MOORE, *supra* note 16.

[19] *See id.* at 117–22.

[20] *See id.*

[21] Bank costs incurred when converting foreign currency into domestic currency. *See* DANIELS ET AL., *supra* note 9, at 231.

(2) theater checking,[22] (3) collections,[23] (4) residuals to talent guilds,[24] (5) trade dues,[25] (6) licenses,[26] (7) taxes,[27] and (8) theater-level advertising.[28]

2. Distribution Fees

Distribution fees are the fees charged by the studio/distributor to distribute a film in a given territory. These fees are usually charged as a percentage of revenue from the designated market and vary between ten and fifty percent depending on the producer's relative bargaining power.[29]

3. Distribution Expenses

Distribution expenses are the costs associated with distributing a film. Distribution expenses include, to relative degrees, each of the following: advertisements and promotions,[30] release prints,[31]

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22 To ensure accurate box office reporting, studios hire theater checkers to actually sit in the theater and do a head count. *See, e.g.*, Certified Reports, Inc., *at* http://www.certifiedreports.com/TheatreServices.asp (last visited Feb. 21, 2003).

23 The cost of collecting fees from and auditing distributors. *See* DANIELS ET AL., *supra* note 9, at 231.

24 Talent guilds include the Directors Guild of America [DGA], Screen Actors Guild [SAG], and Writers Guild of America [WGA], though residuals are also payable to below-the-line (everyone other than the director, writer, producer, or star) guilds such as the International Alliance of Theatrical Stage Employees [IATSE], under various collective bargaining agreements. *See id.* at 162–66, 232.

25 A trade is an organization, such as the MPAA, responsible for protecting and promoting the interests of an industry. They do so by lobbying for protectionist legislation, especially in regard to antitrust matters, discussed *infra* Part III. Their fees are subject to a cap of $75,000. *See* DANIELS ET AL., *supra* note 9, at 232.

26 Fees, including censorship payments to foreign film boards. *See* DANIELS ET AL., *supra* note 9, at 232.

27 Revenue taxes including foreign withholding taxes. *See id.* at 232–33.

28 This is a typical studio "give," meaning it will be negotiated out if requested. *See id.* at 230–33.

29 *See id.* at 295.

30 Recent totals for advertising and promotion: 1997 (22.7 million), 1999 (28 million), 2001 (30 million). Studios define this term broadly, including:

> Advance screenings, market research focus groups, and market tracking studies;
>
> Network television (the most expensive part of the ad campaign, the cost of which local exhibitors do not share);

taxes,[32] residuals,[33] bad debt,[34] and other miscellaneous expenses such as editing costs due to censorship, duties, theater checking, special titles, legal expenses, and settlements.[35]

Cooperative advertising (ad costs shared by the distributor and exhibitor which are negotiable, and may include all media, some media, or only in-theater standees (standing cardboard figures));

Trade Ads (ads taken in trade magazines such as the *Hollywood Reporter* or *Daily Variety*, which are used to stroke Talent egos, attract foreign distributors, get exhibitors to increase bids for films, and drive up the secondary market price of a film);

Four Walling (releasing film theater-by-theater rather than according to a general release plan);

Sneak Previews (such previews include the director's sneak (for which the producer and distributor must agree in accordance with standards set by the DGA), the trade sneak (done mostly for Talent ego and sales, as described above for Trade Ads), and the word- of-mouth sneak (to generate enthusiasm among fans);

Advance Ads (ads that do not include theater names, merely the title of film or star);

Theater Ads (including trailers, marquee, standees, and one sheets);

Billboards and Busses;

Publicity (otherwise known as the art of coaxing media into promoting for free, though a studio may have to pay for Talent to go to a publicity screening (including hotel, air fare, car rentals, and per diem)), or for field promotion (where the studio pays the salaries of fieldpeople (independent agency employees, or employees of the distributor in charge of "local publicity") which are separately chargeable, while ad personnel's salaries usually are not). *See* DANIELS ET AL., *supra* note 9, at 142–43. Publicity may also include featurettes, otherwise known as Electronic Press Kits [EPKs], that show how the film was made. Revenue generated from EPKs should be offset against charges, but this is generally not done because it would be difficult and costly for the profit participant's auditors to locate;

Overhead (most distributors charge ten percent of total ad expense as a contractual overhead amount).

See DANIELS ET AL., *supra* note 9, at 113–47; MOORE, *supra* note 16, at 343, 360–61.

31 The cost of release prints includes the film elements, the freight, and dubbing costs. Generally, costs incurred prior to the final answer print are considered production costs (subject to an overhead charge), while costs incurred afterward are considered distribution expenses. *See* DANIELS ET AL., *supra* note 9, at 149–54; MOORE, *supra* note 16, at 362.

32 Income taxes are not chargeable to a production, though the studio may charge sales, withholding, and remittance taxes. *See* DANIELS ET AL., *supra* note 9, at 155–60; MOORE, *supra* note 16, at 137, 362–63.

33 Residuals are a distribution expense, triggered only if a film is distributed beyond its initial theatrical release. *See* DANIELS ET AL., *supra* note 9, at 161–66; MOORE, *supra* note 16, at 362.

4. Negative Cost

The negative cost is the cost of getting the film "in the can" (i.e., completing the film up through obtaining a final cut negative, but not including release prints, which are more properly deducted as a distribution expense).[36] Another way of looking at negative cost is to view it as the final production budget of the film, after adjustments for actual costs.

Negative costs include, but are not limited to, the production cost,[37] studio overhead of roughly fifteen percent of the direct cost of production, gross participations before breakeven (i.e., when gross receipts = distribution fees + distribution expenses + production costs + interest), interest (usually charged at 125 percent of the London InterBank Offered Rate (LIBOR), and which may be *added on to overhead* and also *charged against unrecouped production costs*, but not unrecouped distribution expenses), and deferments (which may be contingent (on profits) or non-contingent (upon completion of principal photography or upon acquiring a distributor).[38] The important distinction for profit participants between distribution fees and distribution expenses is that the studio may charge overhead on distribution costs, but not on fees, and this interest charge is *always higher than the actual cost of funds*.[39] Profit participations are also included as production costs so that the studio may charge interest and the overhead fee on them to deduct these charges before making any payments.[40]

[34] Bad debt is an uncollectable film rental fee, and should generally not be reported as a distribution expense. *See* DANIELS ET AL., *supra* note 9, at 168; MOORE, *supra* note 16, at 362.
[35] *See* DANIELS ET AL., *supra* note 9, at 169–70; MOORE, *supra* note 16, at 360–64.
[36] *See* DANIELS ET AL., *supra* note 9, at 153.
[37] Including (1) the cost of abandoned ideas, (2) facility charges for use of studio back lots and production offices, (3) payroll tax and fringes varying between twenty-five and forty percent of the salaries of studio and guild employees (and which studios will calculate at the highest rate even though actual amount paid is less), and (4) completion guarantees between three and six percent of the budget (if necessary). *See* DANIELS ET AL., *supra* note 9, at 179–90.
[38] *See* DANIELS ET AL., *supra* note 9, at 190–200.
[39] *See* MOORE, *supra* note 16, at 138.
[40] *See id.*

C. Net Profits: Two Models for Home Video

Net profits for home video are determined on either a license fee or a royalty model.[41]

1. The License Fee Model

The license fee model follows the traditional net profit formula discussed *supra* Part I.A.1: gross profits – (distribution fees + distribution expenses + negative cost). Typically, studios will levy a distribution fee between thirty-five and forty-five, which is similar to a theatrical distribution fee.[42]

2. The Three Royalty Models: Sell-Through, Revenue Share, and Rental

Royalty models are a convenient means by which a studio can get around the myriad deductions of the License Fee model by simply reporting to the profit participant a flat percentage of gross income from wholesale distribution.[43] At some point in every case, varying with the numbers, the license fee model and royalty model for home video will meet;[44] profit participants should, therefore, hire a savvy attorney who is adept at choosing which model will produce the most income.

Royalty models for video distribution fall into three categories: sell-through, revenue share, or rental.[45] Given that the intention of a studio is to calculate and report net profits as low as possible, it is not surprising to find that studios have defined royalties in terms that allow them to categorically reduce gross receipts from video sales, the single largest element of gross receipts, by eighty percent or more.[46]

41 Wayne Levin, Address at Southwestern University School of Law (Feb. 2002).
42 *See id.*
43 *See* DANIELS ET AL., *supra* note 9, at 296.
44 A good rule of thumb is somewhere between a thirty-seven percent royalty and a twenty-two percent distribution fee.
45 *See* DANIELS ET AL., *supra* note 9, at 61–62.
46 *See* MOORE, *supra* note 16, at 135.

a) Sell-through

Sell-through defines the market in which the studio delivers videocassettes to retail outlets for sale directly to consumers at the manufacturer's suggested retail price (approximately $29.95).[47] Royalties in this market are the lowest and vary between ten and fifteen percent.[48]

b) Revenue Share

Revenue Share defines the market in which videos are delivered to retailers at a reduced price and in which the gross profits are split fifty-fifty with the studio, which allows for a slightly higher royalty of approximately eighteen percent.[49]

c) Rental

Rental is the market in which videos are sold to retailers for rental to consumers in exchange for a higher royalty of approximately twenty to thirty percent.[50]

3. Conclusion: The Three Royalty Models Underscore the Need for Accurate and Enforceable Reporting at a Higher Royalty Rate

The current royalty models effectively allow a studio to take a seventy-five to ninety-five percent distribution fee without accounting for costs.[51] While this fee was initially fair, because higher royalties were needed to help pay for developing and marketing a new secondary market, they are now onerous and excessive because all the associated costs have decreased, lowering the cost of duplicating, marketing and distributing a video cassette from forty dollars to three dollars.[52] The studios, however, cling to

[47] *See* DANIELS ET AL., *supra* note 9, at 62.
[48] *See* Harris E. Tulchin, *Licensing Motion Pictures in the International Marketplace, at* http://www.medialawyer.com/LICEART.htm (1999).
[49] *See* WAYNE LEVIN, MOTION PICTURE PRODUCTION LAW 32 (2002).
[50] *See* Tulchin, *supra* note 48.
[51] The distribution fee is essentially the reverse of the royalty fee, i.e., when the distributor pays a royalty of between eight and twenty-five percent, she is, in effect, charging a distribution fee of between seventy-five and ninety-two percent.
[52] *See* DANIELS ET AL., *supra* note 9, at 65.

these antiquated standards for three reasons: first, because they can; second, because increasing the royalty for one retailer would likely increase the royalty for all based on "most favored nations"[53] provisions in standard distributor contracts; and third, because of concerns that higher royalties will incur higher across-the-board payments to guilds.[54] To aggravate matters further, distribution expenses are now creeping back in, reducing the royalty *even further* to approximately eight to twelve percent, regardless of the model chosen.[55]

II. THE ECONOMICS OF INTERNET VIDEO DISTRIBUTION: TWO WAYS IN WHICH INTERNET DISTRIBUTION WILL AFFECT PROFIT PARTICIPANTS

Internet distribution presents a monolithic problem for the film industry, and for profit participants and their attorneys, because it is not clear to anyone drafting these agreements exactly where Internet revenue will fall under current guild agreements.[56] One certainty, however, is that the Talent's share of profit participation will be reduced in two ways. First, when studios take distribution "in-house" (meaning they do it themselves) there will be little, if any, independent oversight, which will lead to under-reporting. Second, when films are distributed online they will be increasingly vulnerable to piracy, with the resulting losses surely passed on to profit participants in the form of write-downs.

53 *See* DANIELS ET AL., *supra* note 9, at 64 n.15 ("A 'most favored nations clause' . . . basically states, 'if anyone else ever gets a better deal, then I get that same better deal.'").

54 *See* DANIELS ET AL., *supra* note 9, at 64.

55 *See id.* at 66–68.

56 *See* Zane B. Melmed, *The Role of the Studio Lawyer in the New Media Age*, 8 UCLA ENT. L. REV. 169, 178 (2001).

A. How In-House Studio Distribution of Home Video May Eliminate the Need for Content Aggregators and Lead to Underreporting

1. The Traditional Home Video Distribution Model

Under the traditional home video distribution model, content aggregators[57] distributed videos to the public. Content aggregators include businesses such as Blockbuster Entertainment, Hollywood Video, and neighborhood video stores, which receive and distribute videos from multiple sources.

2. Benefits of Content Aggregators: Independent Reporting

Content aggregators provide multiple consumer benefits: a wide range of films (not just films from one studio), geographical proximity and convenience, and competitive prices. For Talent, the most important benefit of content aggregators is that they provide independent reporting of gross receipts,[58] because content aggregators are not exclusive distributors of a single studio's product.[59]

3. Detriments of Content Aggregators: Increased Cost

Studios dislike doing business with content aggregators, but view them as necessary evils. First, content aggregators are *necessary* because consumers will not drive to different studio stores, where each store carries only that studio's films.

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[57] "A content aggregator is an individual or organization that gathers Web content (and/or sometimes applications) from different online sources for reuse or resale." *Content Aggregator*, Search Web Services, *at* http://searchwebservices.techtarget.com/sDefinition/0,,sid26_gci815047,00.html (last visited Apr. 16, 2003).

[58] Although detailed reports are available by paid subscription only, limited reporting of gross receipts for video rentals is available to the public through *Hollywood Reporter*, *at* http://www.hollywoodreporter.com/hollywoodreporter/charts/rental_display.jsp (last visited Apr. 16, 2003) (listing of weekly top ten available without paid subscription), *Video Store Magazine*, *at* http://www.videostoremag.com (last visited Apr. 16, 2003) (listing of weekly top ten available without paid subscription), and *Video Business*, *at* http://www.videobusiness.com (last visited Apr. 16, 2003) (listing of weekly top three available without paid subscription).

[59] This is true even though they may be owned by a single studio; e.g., Blockbuster and Paramount are both subsidiaries of Viacom.

Consumers would not know where to go, making it extremely inconvenient for them to find movies, and the selection would be limited. Second, content aggregators are *evil*, as far as studios are concerned, because they increase the studios' cost of doing business and lower the studios' profit margin. Content aggregators increase the studios' cost of doing business by imposing independent reporting and auditing requirements, and they lower the studios' profit margins because studios must split profits under the revenue sharing models discussed *supra* in Part I.C.[60]

4. Why Content Aggregators May Be Eliminated

Much to the studios' delight, Internet video distribution threatens to abolish the need for content aggregators because it will radically change the way consumers rent motion pictures. Instead of going to local video stores, consumers will be able to do a title search on the web, go to the studio website, and download the film. Portal sites[61] may also allow a user to select films according to genre and then link to a studio site, in which case a studio would likely pay the website between one and thirty cents for referrals leading to consumer rentals.[62]

Clearly, content aggregators will seek to continue distributing films online. Although initial efforts to start an Internet venture between Blockbuster and Enron failed,[63] Blockbuster has had some success in securing limited video-on-demand rights from Universal.[64] Furthermore, Blockbuster's president of e-commerce has stated that Blockbuster is firmly committed to "deliver[ing]

[60] *See* David Bloom, *Blockbuster and Enron Blow Out*, Red Herring, *at* http://www.redherring.com/industries/2001/0326/1730018373.html (Mar. 26, 2001) ("Blockbuster . . . generates more than half of Hollywood's domestic income.").

[61] A site that aggregates links to other sites and allows users to hyperlink to those sites.

[62] This estimate is based on current search engine models such as Overture.com. Overture.com is premised on a unique business model, whereby advertisers bid for key words such as "tee shirt," and the highest bidder receives priority ranking in the listings. *See* http://www.overture.com/d/USm/about/news/glance.jhtml (last visited Feb. 19, 2003).

[63] *See* Bloom, *supra* note 60.

[64] *See* Cecily Barnes, *Blockbuster Rolls Film on Video-on-Demand*, CNet News, *at* http://news.com.com/2100-1023-253242.html?tag=bplst (Feb. 27, 2001).

movies to people at home however they want to receive them."[65] With this hope in mind, Karen Raskopf, a spokeswoman for Blockbuster, stated "[w]e are continuing to talk with the studios and no studios have told us no."[66]

However, not saying "no" doesn't mean "yes," especially when the stakes are as lucrative as the $18 billion video rental market.[67] In fact, initial discussions between Blockbuster (eighty-two percent owned by Viacom)[68] and its corporate cousin Paramount Studios (also owned by Viacom)[69] failed when the parties couldn't agree to a deal, with one insider stating that "Hollywood isn't about to give Blockbuster another blank check."[70]

5. How Eliminating Content Aggregators May Affect Profit Participants

Although this change in the distribution model may be insignificant, if not more convenient, for consumers, it poses a significant problem for profit participants who rely on the independence of content aggregators' accounting. If studios no longer have to distribute films through content aggregators, they will be free (1) to set the video rental price, (2) to set the video royalty rate posted to gross receipts, and (3) to report the number of videos rented.

The studios have already taken the initial steps. On November 11, 2002, five of the seven major film studios announced their joint venture, Movielink[71] (the antitrust implications are discussed in Part III.B *infra*). Under the present model, a consumer can rent a film online which will be viewable on his home computer for as little as $1.99–$3.99 per picture for up to one month; however, once the film has been started, it is only available for twenty-four

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65 *Top 25 Click and Mortar Executives*, Internet World, *at* http://www.internetworld.com/magazine.php?inc=060100/6.01cover2.html (June 1, 2000).
66 Reuters, *Studios in Talks to Sell Movies on the Web*, Industry Standard, *at* http://www.thestandard.com/article/0,1902,20510,00.html (Nov. 30, 2000).
67 *See* Bloom, *supra* note 60.
68 *Id.*
69 *Id.*
70 *Id.*
71 *See* http://www.movielink.com (last visited Feb. 19, 2003).

hours before it is permanently erased.[72] Most likely as a result of piracy fears (discussed in Part IV *infra*), the studios are initially releasing slightly more than 170 titles.[73]

Because of the present technological inability of average consumers to watch the films on television, and also the competing video-on-demand and DVD markets, immediate criticism has been leveled at this means of distribution.[74] That said, the studios hope this arrangement will prove attractive because of the low cost, ease of use, and absence of late fees.[75]

Experts have speculated that the most probable model will be either direct distribution or an inter-company license through a closely held affiliate.[76] Direct distribution will give the studios ultimate authority over the rates, as well as how receipts are added and reported. This presents the problem, however, of "at source" reporting. "At source" reporting occurs when income is recorded where it is *received*. In other words, if a studio receives the money directly, then it must calculate the amount owed to profit participants and post it directly into gross receipts without any

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72 *See* Chris Marlowe & Paul Bond, *Studios Unreeling Web Distrib'n: Quintet Movielink Bows Today Amid Mixed Expectations*, HOLLYWOOD REP., Nov. 11, 2002, at 8 (noting that studios generally set prices at about $4.00); Dawn C. Chmielewski, *Major Studios to Launch Net Movie Rentals,* Mercury News, *at* http://www.siliconvalley.com/mld/ siliconvalley/4492236.htm (Nov. 11, 2002) ("Pricing and terms are set by individual studios, with rental fees ranging from $1.99 to $4.95.").

73 *See id.*

74 *See* Marlowe & Bond, *supra* note 72 (quoting Mark Kersey, broadband analyst for ARS, Inc., as stating that "Internet movies-on-demand will remain a niche market for the foreseeable future," and quoting Josh Bernoff, Forrester Research principal analyst, as stating that linking television to a wireless network "is just too much tinkering for Joe Sixpack"); Ben Fritz, *The Next Big Internet Flop*, Slate, *at* http://www.msnbc.com/news/834034.asp (Nov. 12, 2002) ("The press clippings had better be glowing, because as a business, Movielink provides a product for which there is almost no demand.").

75 *Cf. Risky Business? New On-Demand Digital Movies May Not Be Pirate Proof*, TechTV, *at* http://abcnews.go.com/sections/scitech/DailyNews/techtv_digimovie010820.html (Aug. 20, 2001). Recently, Blockbuster has implemented a new plan aimed at encouraging more rentals by reducing late fees, allowing customers to pay a subscription fee between $19.99 and $24.99 per month for unlimited rentals. *See* Stefanie Olsen, CNet News, *Blockbuster Takes Aim at Netflix*, *at* http://news.com.com/2100-1023-949024.html (Aug. 8, 2002).

76 *See* Schuyler M. Moore, *Release of Films on the Internet Gives Rise to Novel Legal Issues*, ENT. L. & FIN., Dec. 1999, at 3.

further deductions. This would result in more money for profit participants and less for the studio.

Therefore, it is more likely that studios will distribute through an inter-company license with a wholly-owned subsidiary. This model gives the *appearance* of propriety while still allowing the studios to legally redistribute profits to their affiliate, and away from profit participants, by entering into agreements that favor their affiliate-licensees. Under this model, the "source" is the affiliate, not the studio, and thus more deductions can be taken before posting earnings from Internet distribution to gross receipts.[77]

This granting of rights among closely held corporations occurs now more than ever, as vertically integrated studios create their own programs and then license and distribute them through affiliates.[78] It has caused an industry-wide panic among Talent and Talent representatives, because it allows the licensee (which has no contractual obligation to Talent) to earn the lion's share of the profits while the studio posts reduced figures to the profit participation pool shared by Talent, thus permitting a studio to legally avoid its contractual obligation to share profits.[79]

One result of this pro-studio/anti-Talent licensing scheme was the high-profile failure of a proposed NBC sitcom because its producer could not ensure a fair market return on the series.[80] In that dispute, Adam Sandler's Happy Madison production company pulled out of negotiations with NBC for its Norm Macdonald–Jon Lovitz buddy comedy because Sandler couldn't prevent the studio from cutting a sweetheart affiliate deal that would diminish his profit participation windfall if the sitcom became successful.[81] At the heart of the dispute was the studio's recent revision in its

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77 *See id.*

78 *See* John Dempsey, *April Fills Cablers with Ratings Thrills*, VARIETY, May 6–12, 2002, at 36 (quoting Brad Adgate, senior vice president and director of research for Horizon Media: "Vertical integration has changed the model. It's not broadcast vs. cable any more, it's media conglomerate vs. media conglomerate.").

79 *See* Janet Shprintz, *Self-Dealing Sets Backend Furor*, VARIETY, Sept. 20–26, 1999, at 4.

80 *See* Cynthia Littleton, *Self-Dealing Pains TV Biz: Talent, Studios Battle Over Back-End Deals*, HOLLYWOOD REP., Mar. 21, 2001, at 1, 41.

81 *See id.*

contractual language, replacing the studio's obligation to secure fair market value for the program with a provision to negotiate in good faith.[82] This alteration was based upon the studio's unilateral assessment that "fair market value is a difficult, if not impossible, standard to determine in the current media landscape, where media giants are doing more and more internal business and the pool of potential buyers is shrinking."[83] However, such a provision effectively eviscerates the rights of profit participants because it is so subjective. Essentially, the studio replaced a standard that was difficult to determine with one that was wholly unenforceable without litigation, and solely within its discretion.

NBC has since revised this provision to stipulate that the studio must "secure fees in line with the amount the studio would in a transaction with an unaffiliated buyer for a comparable program."[84] However, under the current trend of deregulation, it is not likely that such a value could be determined, because nearly *all* studios are licensing to affiliated companies.[85] Therefore, this form of self-dealing through transfer pricing in affiliated transactions is an industry-wide issue that has become "grist for numerous lawsuits in recent years as consolidation and vertical integration [have] yielded media behemoths that house production and network entities under one corporate roof."[86]

So far, the lawsuits that have been filed against the studios have settled[87] based upon the studios' fear that they would be required to disclose their confidential license fee agreements.[88] Nevertheless, settlements only protect Talent powerful enough to sue without fearing that a backlash from the studio might end their

[82] *See id.*
[83] *Id.* at 41.
[84] *Id.*
[85] *See* Shprintz, *supra* note 79.
[86] *See* Littleton, *supra* note 80, at 1.
[87] *See id.* at 41 (citing lawsuits against Twentieth Century Fox TV over profits from the shows *NYPD Blue* and *The X-Files* based on licensing arrangements between Fox Broadcasting Co. and its FX cable network; a lawsuit by Barry Levinson and Tom Fontana over profits from *Homicide: Life on the Street*; and a lawsuit by the creators of *Home Improvement*).
[88] *See id.* (stating that studio executives equate discovery with blackmail because plaintiffs can subpoena confidential license fee agreements).

career.[89] Furthermore, studios are already nipping lawsuits in the bud by inserting new contractual language effectively spelling out the rights of the studio to sell to an affiliate, as well as engage in a self-dealing transaction, with all disputes subject to mandatory binding private arbitration.[90] This is hardly a solution to the problem, since private arbitration will keep disputes out of the public eye, limit discovery, and not be subject to appeal.[91]

If past behavior is any indication, studios will neither be honest nor forthcoming when providing statements to profit participants.[92]

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89 *See id.* (quoting veteran entertainment litigator Stanton "Larry" Stein, who stated "most of the talent involved just doesn't have the clout to say 'no' because they won't get their projects picked up").

90 *See* Shprintz, *supra* note 79.

91 *See* MOORE, *supra* note 16, at 188.

92 Some noteworthy examples of Hollywood's untrustworthiness are:

- In November 2002, the California Court of Appeals let potentially devastating jury instructions stand following appeal by the Walt Disney Company. *See* Stephen Slesinger, Inc. v. Walt Disney Co., No. B153920 , 2002 WL 31590870 (Cal. Ct. App. filed Nov. 20, 2002); Janet Shprintz, *Winnie Ruling Wallops Disney*, DAILY VARIETY, Nov. 21, 2002, at 1, 24. The case involved damages that could amount to $1 billion resulting from Disney's promise to pay videocassette royalties to the Slesinger family, which has held North American rights to Winnie the Pooh since the 1960s. The court found that "Disney misused the pretrial discovery process by destroying evidence it knew or should have known was sought by SSI [including a file marked "Pooh-Legal Problems"], making false and evasive responses to SSI's discovery, and unduly delaying notification about the records destruction." *Slesinger*, 2002 WL 31590870, at *2. Consequently, by applying a jury instruction "as to the suppression, concealment, and destruction of evidence", the court let stand jury instructions permitting the jury to find that the representations regarding royalties had been made, that Disney was prohibited from introducing evidence disputing SSI's version of statements attributed to Disney, and allowing the jury to find that such representations were knowingly false when made. *Id*. Notwithstanding *Slesinger*, Disney had the chutzpah to separately negotiate an agreement with the heirs of the Pooh books author and illustrator in a move that would allow Disney to reclaim the merchandising rights from the Slesinger family—this agreement is being separately contested. *See* Shprintz, *supra* at 79.
- In November 2002, legendary comic book creator Stan Lee filed suit in the U.S. District Court for the Eastern District of New York because Marvel Comics claimed that, despite the $800 million in worldwide box office sales, SPIDER-MAN (Columbia Pictures 2002) had not generated a profit. *See* Carl DiOrio, *Lee's 'Spider' Suit: Case vs. Marvel Turns on Licensing Profits*, DAILY VARIETY, Nov. 13, 2002, at 8.
- In 1995, Winston Groom, the writer of FORREST GUMP (Paramount Pictures 1994), publicly complained that Paramount had not paid him a single penny of his

Commenting on the creative practices underlying "Hollywood Accounting," one industry insider has said his mentor at "Universal kept no fewer than five sets of books for any given production," while another swears with equal vehemence that Universal kept "only a single set of books . . . for any given purpose."[93] Semantics aside, the principal question that taking video distribution in-house poses to profit participants and that Talent will litigate in the near future will be "how can a profit participant prevent the underreporting problem that Internet distribution poses?"[94]

B. *How Can Profit Participants Prevent Underreporting?*

1. The Independent Audit

As a matter of course, studio profit participation statements are audited by profit participants with clout in the film industry, because "participants generally don't trust the good graces of the

three percent net profit participation after the film had grossed over $660 million worldwide to become one of the best selling films of all time. *See* Kim Masters, *Hollywood Is As Hollywood Does:'Gump' Author Nets Success, Not Big Bucks*, WASH. POST, May 27, 1995, at C1. The studio later placated the author by paying him one million dollars for the film rights to his next book. *See* Paul F. Young et al., *Par Buys 'Gump' Book Sequel*, VARIETY, June 19–25, 1991, at 19.

- In 1995, the heirs of Jim Garrison, the late New Orleans district attorney who wrote *On the Trail of the Assassins*, upon which the Oliver Stone film JFK (Warner Bros. 1991) was based, sued Warner after the film earned over $150 million in gross receipts, but failed to show a net profit. Garrison v. Warner Bros., Inc., 1996 WL 407849 (9th Cir. 1996). A detailed synopsis of the case and pleadings can be found at *Garrison v. Warner Brothers*, *at* http://www.courttv.com/legaldocs/business/ garrison.html (last visited Feb. 8, 2003).
- In 1982, Art Buchwald, an internationally renowned writer and humorist, sued Paramount Pictures, including then head of motion picture production, Jeffrey Katzenberg, for stealing his three-page screen treatment entitled *It's a Crude, Crude World* and turning it into COMING TO AMERICA (Paramount Pictures 1988). At the time, Katzenberg had a high regard for the concept as a movie, describing it as "a succinct, smart, straightforward idea with a lot of potential to it" which he apparently had no compunction stealing. *See* Buchwald v. Paramount Pictures Corp., 13 U.S.P.Q.2d (BNA) 1497 (Cal. App. Dep't Super. Ct. 1990).

93 DANIELS ET AL., *supra* note 9, at 212–13.

94 Moore, *supra* note 76.

distributor to ensure that their interests are being looked after."[95] Similar practices are rampant in the recording industry, where many labels are owned by the same principal entities.[96] Though audits are often the only realistic remedy for curing suspected reporting errors, they are often ineffective because standard contracts allow the studios to approve of the auditor.[97] This permits the studios to choose an auditor favorable to their interests, and release only limited records of the film company, as opposed

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[95] DANIELS ET AL., *supra* note 9, at 271.

[96] *See* Tamara Conniff, *Artists Sing Protest Songs: Labels Upbraided at State Hearing on Accounting*, HOLLYWOOD REP., Sept. 25, 2002, at 1, 31. This article is indicative of the widespread dissatisfaction of artists with accounting practices. It begins by stating that "audits are a luxury only top-selling artists can afford, leaving many midlevel acts without any means of being properly compensated." *Id.* at 31. Noteworthy quotations include: (1) Don Henley, recording artist and founder of the Recording Artists Coalition, vilifies the accounting practices of the five major record labels stating "[t]here is no penalty for negligence and underreporting"; (2) Simon Renshaw, manager for the Dixie Chicks, stating after a $20 million settlement that for every client he has represented with respect to royalty payments in the last twenty years, the accounting has "always been wrong, without exception"; (3) country recording artist Clint Black stating "I'm not an accountant, [but I made] $150 million for the record company [and] I could not find anyone in my organization to explain to me how [it] could be possible [that I owed them money]"; (4) Kathryn Crosby, widow of Bing Crosby, stating "I can tell the difference between 7% and 15%" resulting from millions of dollars in underpayments of royalties dating from the 1940s; (5) Jennifer Warnes, Oscar and Grammy winning artist stating that the royalty statements are "impossible to understand" and that the labels were "dishonest and inaccurate"; and (6) Ruben Blades, actor and recording artist, stating that the accounting procedures were a "bilingual rip-off." *Id*. Interestingly, the response from the labels was to try to minimize the gravity of the harm by (a) stating that settlements accounted for only 4% of royalties earned (Paul Robinson, Senior Vice President, Warner Music Group); (b) stating that artists earning 17% on revenue make more than labels earning 9% on revenue (Linda McLaughlin, industry-hired economist); (c) accusing artists of separatism and myopia—"fiddling while Rome burns" and stating that "[t]his royalty reporting debate, however well-intentioned it may be, is distracting all of us from the very pressing need to band together on . . . piracy, which is taking a huge toll on the record business" (Paul Robinson); and (d) attacking the artists' integrity, calling artists "offensive and malicious to malign an entire industry based on stereotypes, innuendo and myths" (Cary Sherman, President, Recording Industry Association of America [RIAA]). *Id.* This author finds the industry's arguments to be transparently inaccurate and self-serving because (a) 4% of royalties earned is no small amount when it totals in the hundreds of millions of dollars; (b) incredibly few artists make more than labels, and, even so, the artists deserve the money because it is *their work* and most have short careers; (c) solidarity with respect to piracy has nothing to do with underreporting, and, following the Rome analogy, if the artist is Caesar, "et tu Brute?"; (d) repeated specific instances of underreporting are not stereotype, innuendo, or myth; they are reality.

[97] *See* MOORE, *supra* note 16, at 139.

to their general ledgers or underlying contracts that would show unreported income or rebates.[98] Furthermore, an audit does not give the profit participant the right to inspect the books of affiliates, who may be sheltering income.[99] Therefore, there is no meaningful ability to cross-check amounts posted as income, because the affiliates are not parties to the contract between the studio and the profit participant. Additionally, auditors are generally not given the right to copy documents (inhibiting full review), Talent does not receive back interest on monies owed, and Talent must pay for the audit, even in cases of gross under-compensation.[100] Therefore, even though audits are common practice, they are not an effective means of ensuring accurate profit participation because they are based on insufficient information, studios do not have to disgorge the interest on monies improperly retained, and Talent bears the risk of paying for most audits whether or not they are successful.

2. Litigation

Litigation is costly but quite effective, because the threat of exposure through discovery often forces a studio to settle rather than divulge confidential books that would reveal further abuses.[101] If Talent possesses both the wherewithal and sufficient power to prevent litigation from becoming career quicksand, this is probably the most effective means for obtaining relief.

3. Guilds & Arbitration

Guilds are some of the most powerful forces in Hollywood. One way that Talent could help ensure accurate reporting is to have auditors appointed by the guilds, not the studios, or at least be appointed in equal proportions. Another provision Talent could include is to have any profit participation dispute subject to binding arbitration by their respective guild representatives. While such an appointment would clearly help protect Talent's rights, it

98 *See id.*
99 *See id.*
100 *See id.*
101 *See* Littleton, *supra* note 80.

may prove too cumbersome, because, again, the provisions are *bargained for*, and thus not mandatory and subject to guild agreements. In addition, Talent may elect "audit and arbitration," thereby over-taxing guild resources and creating further animosity between guilds and studios which have led to tremendous work stoppages[102] and runaway production.[103]

4. Legislation

Talent may follow the lead of recording artists and push for legislation that would establish statutory penalties for, or criminalize, improper accounting practices.[104]

5. Establish a Fiduciary Duty

Talent may also wish to introduce legislation under state business and professional codes to establish that breaching an obligation to pay royalties breaches a fiduciary relationship.[105]

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[102] The WGA went on a twenty-two-week strike in 1998 leading to losses estimated in the hundreds of millions of dollars and only questionable gains. *See* Dave McNary, *Will Biz Replay '88 Labor Bloodbath?*, VARIETY, May 22–28, 2000, at 7. Thereafter, the threatened writers strike of 2001 gave writers enough leverage to secure a three-year contract, providing a $41 million gain when studios sought to prevent an estimated $6.9 billion dollar loss to the city of Los Angeles. Michael Mahern, a negotiator for the WGA, described this gain as the "best economic package that the Writers Guild has achieved since 1977." *See Hollywood Writers Clinch Deal with Producers*, CNN, *at* http://www.cnn.com/2001/SHOWBIZ/TV/05/04/writers.guild.02 (May 4, 2001).

[103] Runaway production (films shot outside Los Angeles) became one of the biggest problems for guilds during the 1990s, as producers seeking to lower their film budgets by avoiding onerous guild payments shot more and more films in Canada, Australia, and elsewhere. Numerous articles belabor the labor and civic losses that result when films are shot outside of Los Angeles. *See* James Bates, *Marketing the State's Virtues to Filmmakers*, L.A. TIMES, Apr. 15, 2002, at C1; Meg James, *Valenti Says He's Against Tariffs; Entertainment: Film Industry's Chief Lobbyist Tells Canadians He Supports Tax Credits to Keep Production in U.S.*, L.A. TIMES, Feb. 8, 2002, at C4; *Leaving Los Angeles: Expo Highlights New Horizons: City Film Commissioners Unhappy with 'Runaway Production'*, CNN, *at* http://www.cnn.com/2000/SHOWBIZ/Movies/02/29/locations/index.html (Feb. 29, 2000).

[104] *See* Conniff, *supra* note 96 (in which California Senators Kevin Murray, D-Culver City, and Martha Escutia, D-Norwalk, announced that they may introduce such legislation to help settle the "long simmering issue" of recording industry accounting practices which has led to "a lot of angry [artists] out there").

[105] *See id*.

6. Antitrust Law

Antitrust law focuses less on the agreements themselves than on how the agreements are by-products of unequal bargaining power between studios and Talent. In the context of in-house Internet video distribution, the recent prevalence of entertainment media mega-mergers threatens to abolish Talent profit participation entirely because studios will most likely distribute through closely held affiliates, thereby secreting profits into companies with which Talent has no privity and therefore cannot reach. This argument is more fully developed in Part III.

III. PUBLIC POLICY: WHO BENEFITS AND SHOULD THEY?

A. Are Studios Unfairly Arrogating Profits?

As stated previously, profit participations are creatures of contract, and every contract implies an obligation of good faith and fair dealing. Although studios will argue that contractual profit participation provisions are entered into freely and knowingly by willing parties represented by experienced lawyers, the truth is that the definitions cannot be, and are not in fact, negotiated.[106] It is, therefore, even more critical that when a studio contracts with Talent for profit participation, part of their contractual obligation is to uphold their duty to report profits accurately and honestly so that Talent will receive the benefit of their bargain. Traditionally, however, this has not been the case.

1. Unequal Bargaining Power and the "Monkey Point" Problem

Historically, the introduction of new technologies to the film industry has operated to artists' detriment.[107] In 1960, the WGA went on strike, insisting on artist royalties for films released on

[106] *See* DANIELS ET AL., *supra* note 9, at 211.

[107] *See* Jeffrey K. Joyner, *Future Technology Clauses*: *Would Their Lack of Compensation Have Discouraged Shakespeare's Creativity and Denied Society's Access to His Works in New Media?*, 31 SW. U. L. REV. 575 (2002).

television, and received non-retroactive compensation.[108] In 1973, the WGA again confronted the issue of profit participation with the advent of home video.[109] At that time, the WGA successfully defined and set a participation standard for writers.[110]

Currently, new technologies are covered in "future media" clauses, usually drafted as all media "now known or hereinafter created."[111] The fundamental purpose of this clause is to have Talent assign away their rights to profits from those media.[112] The fact that such a clause even exists in a Talent contract underscores the plain fact that "there is unequal bargaining power between the two sides [artists and studios] and the [artist] doesn't feel as if he or she can say no because their career is at risk if they do."[113]

Furthermore, in *Buchwald v. Paramount Pictures Corp.*, the court noted that if Talent who lack "the 'clout' of major stars [wish] to work in the film industry [they] must do so on terms substantially dictated by the studio."[114] Since it is commonly understood that 95% of all actors are non-working actors, it is self-evident that most of the industry's Talent occupy weak bargaining positions.[115] Clearly, the implications are that since most Talent are relegated to weak bargaining positions, their profit participations will be minimal, and the realization of such profits is

[108] *See* Dave McNary, *Showbiz Faces Labor Pains*, VARIETY, Mar. 27–Apr. 2, 2000, at 1.

[109] In 1971, Sony invented the U-Matic video cassette recorder [VCR], beginning a revolution in the secondary market for film distribution. *See The Betamax Versus VHS Battle*, Jones Telecommunications and Multimedia Encyclopedia, *at* http://www.digitalcentury.com/encyclo/update/sony.html (last visited Feb. 8, 2003).

[110] *See 2001 Negotiations, Negotiations Alert, History: A Look Back: Progress and Sacrifice*, WGA West, *at* http://wga.org/negotiations/alert0700.html (last visited Feb. 28, 2003).

[111] *See* Alex Alben, *Future Technology Clauses and Future Technologies Legal Roadblocks to New Media Uses Along the Information Super Highway*, ENT. L. REP., Mary 1994, at 3, 11.

[112] *See id*.

[113] Dave McNary & Paul F. Duke, *Rewriting the Rules: Writers Guild Fights Studios over Draft Notices*, DAILY VARIETY, Apr. 28, 2000, at 12.

[114] Michael Rudell, *The 'Buchwald' Case–Phase 2*, N.Y.L.J., Jan. 25, 1991, at 3 (citing Buchwald v. Paramount Pictures Corp., 13 U.S.P.Q.2d (BNA) 1497 (Cal. App. Dep't Super. Ct. 1990)).

[115] *Cf.* McNary, *supra* note 113, at 12 (stating that there is unequal bargaining power between writers and studios).

considered illusory: what Eddie Murphy colloquially referred to as "Monkey Points."[116] "Monkey Points" is an appropriate term, because regardless of the apparent profitability of any particular film, the studio invariably claims that the film was not profitable.[117] The "Monkey Point" problem is exacerbated by vertical integration, a problem presented by both the direct and inter-company in-house distribution models, which further exclude the artist from gaining access to independent reporting sources.

B. Antitrust Implications?

1. Vertical Integration Prohibited

There were many important things happening in 1948. In the film world, it was a "revisionist" period that reexamined and reevaluated the Great American Dream. Jack Warner churned out "gritty" realist social dramas at Warner Studios,[118] catapulting character actors like Humphrey Bogart[119] and Bette Davis[120] into that rarefied realm of stardom previously reserved for matinee idols such as Clark Gable[121] and Claudette Colbert.[122] In the realm of politics, the nation was rebuilding. America had just emerged

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[116] DANIELS ET AL., *supra* note 9, at 225.

[117] *See* Masters, *supra* note 92 (Paramount claimed no profits after FORREST GUMP (Paramount Pictures 1994) grossed over $660 million worldwide).

[118] Jack Warner helped found Warner Brothers in 1923 with his brothers Harry, Albert, and Sam. He was the head of Burbank Studios during its most popular era in the '30s and '40s and sold his remaining interest in the studio in 1967 to a commercial syndicate. *See A Warner Brothers Retrospective*, *at* http://www.meredy.com/warnerbros (last visited Feb. 8, 2003).

[119] Humphrey Bogart starred in TREASURE OF THE SIERRA MADRE (Warner Bros. 1948) and KEY LARGO (Warner Bros. 1948).

[120] Bette Davis starred in ALL ABOUT EVE (Twentieth Century Fox 1950), ANOTHER MAN'S POISON (Image Entertainment 1952), and PHONE CALL FROM A STRANGER (Twentieth Century Fox 1952) in the post-war years.

[121] Clark Gable starred in IT HAPPENED ONE NIGHT (Columbia Pictures 1934), MUTINY ON THE BOUNTY (MGM 1935), IDIOT'S DELIGHT (MGM 1939), and GONE WITH THE WIND (Selznick International Pictures 1939) during the pre-war years.

[122] Claudette Colbert co-starred in IT HAPPENED ONE NIGHT (Columbia Pictures 1934) with Clark Gable (which won an Oscar for best picture). She also starred in CLEOPATRA (Paramount 1934), THE GILDED LILY (Paramount 1935), SHE MARRIED HER BOSS (Columbia 1935), THE FASHION SIDE OF HOLLYWOOD (Paramount 1935), and IT'S A WONDERFUL WORLD (MGM 1939) during the pre-war years.

from one of the most devastating human tragedies on record, and President Truman was busy restoring confidence to a nation that had lost 295,000 lives to war.[123] The exceptional productivity of this time helped screen out the images of desolation left by the war and gave Americans a forward looking optimism, which would lead to the carefree idealism of the 1950s.

It was a period when the strong became stronger, yet a sense of dignity and responsibility prevailed, set by Truman's own moral imprimatur as a former county judge.[124] Equity was a central concern of the Democratic Congress[125] and the courts, and the single most significant manner in which equity was applied to the commercial world was through the Sherman Anti-trust Act of 1890.[126]

The Sherman Anti-Trust Act is a federal law prohibiting "[e]very contract, combination . . . or conspiracy, in restraint of [interstate or foreign] trade . . . ."[127] Its primary targets are unlawful monopolies that impose *unreasonable* restraints on trade,[128] punishing unlawful monopolistic behavior with imprisonment for up to three years, individual fines up to $350,000 per violation, and corporate fines up to $10 million per violation.[129]

The leading case of the post-war era to use the Sherman Act to prevent unlawful monopolistic behavior in the entertainment

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[123] *See World War II Fatalities*, *at* http://www.stokesey.demon.co.uk/wwii/casualty.html (last visited Feb. 8, 2003).

[124] *See FAQ: How Could Truman Be a "Judge" if He Did Not Graduate from Law School?*, Truman Presidential Museum and Library, *at* http://www.trumanlibrary.org/trivia/judge.htm (last visited Feb. 8, 2003).

[125] Part of Truman's winning platform consisted of reducing the cost of government, instituting stand-by wage price controls, promoting federal laws to end job discrimination, decreasing taxes for low-income people, raising the minimum wage from forty to seventy-five cents per hour, using federal funds to provide low-cost housing and permanent price supports for farmers, and creating a national health program. *See Comparing the 1948 Platforms*, Truman Presidential Museum and Library, *at* http://www.trumanlibrary.org/whistlestop/study_collections/1948campaign/large/docs/student_activities/sta12-1.htm (last visited Feb. 8, 2003).

[126] 15 U.S.C. §§ 1–7 (2000).

[127] 15 U.S.C. § 1.

[128] *See generally* BUTLER SHAFFER, IN RESTRAINT OF TRADE: THE BUSINESS CAMPAIGN AGAINST COMPETITION, 1918–1938 (1997) (analyzing the issue of unfair competition).

[129] *See* 15 U.S.C. § 1.

industry was *United States v. Paramount Pictures, Inc.*[130] In *Paramount*, the Supreme Court held the vertical integration of production, distribution, and exhibition achieved by the five major film studios to be an unlawful restraint on trade.[131] The facts of the case reveal that the studios had exerted their considerable leverage in a concerted scheme of price fixing coupled with unreasonable clearances to prevent competition by independent exhibitors.[132]

2. The Return to Vertical Integration

Since that landmark case was handed down, however, the pendulum has swung in the opposite direction and, despite Judge Richard Posner's contention that "antitrust doctrine is supple enough, and its commitment to economic rationality strong enough, to take in stride the competitive issues presented by the new economy,"[133] courts have consistently ruled *against* finding antitrust violations.[134] This is true despite the fact that the Truman administration would likely be shocked by the conglomerations of vast amounts of power in the hands of very few modern media giants today.

The purblind acquiescence of the executive, legislative, and judicial bodies is unprecedented, and their fealty to the corporations that assure their future livelihood cannot be understated. Within the last ten years, Congress, the courts, and administrative agencies have relaxed most restrictions on national media ownership.[135]

The signs of re-integration were initially faint, but clear. In the 1990s, the legislature began to remove the restraints on vertically integrated production, distribution and exhibition, effectively

130 334 U.S. 131 (1948).
131 *See id.*
132 *See id.* at 145–47.
133 Richard A. Posner, *Address: Antitrust in the New Economy*, Tech Law Journal, *at* http://www.techlawjournal.com/atr/20000914posner.asp (Sept. 14, 2000).
134 *See* Lawrence A. Sullivan, *Is Competition Policy Possible in High Tech Markets?: An Inquiry into Antitrust, Intellectual Property, and Broadband Regulation As Applied to "The New Economy"*, 52 CASE W. RES. L. REV. 41, 61 (2001).
135 *See* Jerome A. Barron, *Globalism and National Media Policies in the United States and Canada: A Critique of C. Edwin Baker's Media, Markets, and Democracy*, 27 BROOK. J. INT'L L. 971, 980 (2002).

overturning *Paramount*.[136] In 1995, the Federal Communications Commission (FCC) eliminated the Financial Interest and Syndication (hereinafter "Fin-Syn") Rules.[137] The Fin-Syn Rules were designed to prevent major networks from distributing and profit sharing in domestic syndication, and to restrict their activities in foreign markets to distributing programs that they exclusively produced.[138] Critics have charged that "independent and creative programming [have] been stamped out by the repeal of fin-syn."[139] Over the next several years to the present, the FCC eliminated most of the Chain Broadcasting Rules, which limited the duration of affiliate agreements and the number of TV stations a network could own, citing the high degree of competition introduced by satellite, cable and videocassette.[140]

Then, in September 1999, the FCC eliminated the duopoly rules in favor of a "waiver" system for the top television markets.[141] Previously, the duopoly rules prevented television broadcasters from owning two of the top four stations in a single market.[142] Following this decision, however, media owners could petition to own more than one station absent a showing of prejudice against the minority owners.[143]

Finally, in February 2002, the Court of Appeals for the District of Columbia struck down and remanded for reconsideration the FCC rules limiting media ownership of television stations to thirty-five percent of the national television audience, holding that such a limit was "arbitrary and capricious and contrary to law."[144] The

[136] United States v. Paramount Pictures, Inc., 334 U.S. 131 (1948).

[137] *See* T. BARTON CARTER ET AL., THE FIRST AMENDMENT AND THE FIFTH ESTATE 681 (5th ed. 1999).

[138] *See id.* at 668.

[139] Pamela McClintock, *FCC Is Owning Up: Media Regs Are Outdated, Studies Find*, DAILY VARIETY, Oct. 2, 2002, at 14.

[140] *See* CARTER ET AL., *supra* note 137, at 666–67, 686–89. This rationale would, by extension, apply to the Internet.

[141] *See* 47 C.F.R. § 73.3555 (1999).

[142] *See* FCC Review of the Commission's Regulations Governing Television Broadcasting, Television Satellite Stations and Review of Policy and Rules, 47 C.F.R. pt. 73.

[143] *See id.*; CARTER ET AL., *supra* note 137, at 612.

[144] Fox Television Stations, Inc. v. Fed Communications Comm'n, 280 F.3d 1027, 1033 (D.C. Cir. 2002), *amended by* 293 F.3d 537 (D.C. Cir. 2002).

court set no guidelines for determining what limit would not be "arbitrary and capricious."[145] However, given both the legislative and judicial permissiveness evident in the decision not to challenge the purchase of Chris-Craft by Fox, which resulted in Fox owning forty-one percent of the national television audience prior to this decision, it can be inferred that a forty-one percent limit was tolerable.[146] In that same decision, the court also vacated the cable-broadcast cross-ownership rule,[147] under which a single company could not own a cable television system *and* a TV station in the same city, because the court found it "unlikely the [FCC would] be able on remand to justify retaining it."[148]

Presently, FCC Chairman Michael Powell is reviewing all of the FCC regulations with respect to ownership, and he is leaning toward deregulation and merger. On October 1, 2002, the FCC released twelve studies suggesting the abandonment of (1) the national cap of thirty-five percent on broadcast media ownership designed to ensure that local audiences receive local programming; (2) the duopoly rule, because the number of media outlets has increased by an average of 195 percent since 1960 while the number of independent owners has increased by 139 percent; and (3) the cross-ownership rules, despite a survey of the 2000 presidential election which showed that in ten markets where waivers had been granted, half of the co-owned companies reported the news with similar bias.[149]

Following this report, FCC Chairman Powell has fast-tracked the review of the ownership rules, granting only a thirty-day extension for public commentary on the studies[150] and indicating

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145 *See id.*

146 *See id.* at 1036; Jayson Blair, *Two Stations, One Tabloid, One Owner*, N.Y. TIMES, July 26, 2001, at B1 (noting the FCC's approval of Fox's acquisition of Chris-Craft for $4.4 billion). This deal allowed Fox to temporarily become the nation's largest media owner. At that time, Fox owned two stations in Los Angeles, two in New York, and two in Phoenix, and had an aggregate total of forty-one percent of the national television market despite the thirty-five percent FCC ownership limitation. *See id.*

147 *See* 47 U.S.C. § 533(a) (2000).

148 *Fox Television Stations*, 280 F.3d at 1033.

149 *See* McClintock, *supra* note 139, at 14.

150 *See* Pamela McClintock, *FCC Extending Deadline for Public Say on Studies*, DAILY VARIETY, Nov. 6, 2002, at 8.

that there is no need for public hearings.[151] Critics of Powell's approach have called the studies skewed,[152] revealing a "deeply flawed perspective that while ratifying the chairman's view fails to adequately assess the realities of the news and entertainment media marketplace."[153] Powell has consistently defended his position, stating that the "FCC is committed to achieving its longstanding goals of diversity, competition and localism in the media and has taken significant steps to ensure that the public has a full and fair opportunity to participate."[154] However, Mona Mangan, Executive Director of the 12,000 member WGA, has expressed concern with Powell's genuineness, stating that "[r]adio and television are not just profit centers for large corporations but are precious national assets. Our job is to preserve and protect them in the interest of democracy."[155] With the recent replacement of Senator Fritz Hollings, D-South Carolina, by Republican Senator John McCain, R-Arizona, to the chair of the Senate Commerce Committee, it is almost certain that the ownership rules will be relaxed or abandoned, as evidenced by his comments that the rules are "anachronistic" and "unnecessary."[156] The result of all of these decisions has been the unsurprising but inevitable return to vertical integration.[157]

3. The Studios' Justification

The film studios have justified this return to vertical integration by citing the increase in the post-theatrical film market (i.e., video, DVD, video-on-demand, near-video-on-demand, pay-per-view,

[151] *See* Dave McNary, *FCC Commish Backs WGA*, DAILY VARIETY, Nov. 25, 2002, at 8.
[152] *See* McClintock, *supra* note 150, at 31.
[153] McClintock, *supra* note 139, at 1 (quoting Jeffrey Chester of the Center for Digital Democracy).
[154] McClintock, *supra* note 150, at 31.
[155] McNary, *supra* note 151, at 8.
[156] *See* Brooks Boliek, *Regs Rewrite on Fast Track: Senate Power Shift Makes Ownership Rules Top Priority*, HOLLYWOOD REP., Nov. 7, 2002, at 1.
[157] One interesting casualty of the deregulation war was Department of Justice antitrust chief Charles James, who negotiated Microsoft's controversial antitrust settlement. James was accused of coming in with a strong case and writing a "softball settlement" filled with loopholes that gave no effect to curbing Microsoft's anti-competitive behavior. Eerily, James later stepped down to become general counsel of ChevronTexaco. *See* Paul Davidson, *Antitrust Chief to Leave Justice Post*, USA TODAY, Oct. 4, 2002, at 2B.

pay TV, free TV, and the syndication market). At first blush, this reasoning may appear sound. As far back as 1980, worldwide revenues for video constituted only thirty percent of the projected theatrical revenues.[158] Currently, however, video revenues have *surpassed* theatrical revenues for most films,[159] and that is where studios reap the majority of their profits, because their margins are much higher than for a typical theatrical release.[160]

The studios' reasoning finds support in the Chicago school analysis of vertical integration. This position holds that vertical integration should be per se legal[161] because vertical integration is either competitively neutral or pro-competitive.[162] This kind of thinking predominated the Reagan era, and under both the Reagan and Bush Antitrust Divisions, the Department of Justice only prevented a single vertical merger.[163] Ironically, this was the proposed merger between Showtime and The Movie Channel with a number of film distributors.[164]

Additionally, one might argue that because the studios own their films they have a right to exploit them as they see fit. This argument finds support under the traditional market ethos that there is an "Invisible Hand" which regulates market pricing and availability.[165]

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[158] Michael Blaha, Lecture at Southwestern University School of Law (Spring 2002) (Mr. Blaha is an entertainment attorney and former Vice President of Legal Affairs at Columbia Pictures).

[159] *See* Tulchin, *supra* note 48 (stating that in the late '80s and early '90s worldwide video revenue surpassed revenue from theatrical distribution and other media).

[160] Typically, a theatrical distribution fee is 40%, whereas it effectively varies between 75–92% for home video based on either the "rental" (18–25%), "revenue share" (12–18%), or "sell-through" (8–12%) models. *See* MOORE, *supra* note 16, at 134–35, 140.

[161] *See* Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6, 8 (1981).

[162] *See* ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 225–31 (1978).

[163] *See* Michael H. Riordan & Steven C. Salop, *Evaluating Vertical Mergers: A Post-Chicago Approach*, 63 ANTITRUST L.J. 513, 514 (1995).

[164] For a detailed discussion of the proposed merger and related antitrust issues, see Lawrence J. White, *Antitrust and Video Markets: The Merger of Showtime and the Movie Channel As a Case Study*, *in* VIDEO MEDIA COMPETITION: REGULATION, ECONOMICS AND TECHNOLOGY 338 (Eli M. Noam ed., 1985).

[165] *See generally* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (R.H. Campbell et al. eds., Liberty Classics 1981) (1776) (studying

4. Is the Studios' Reasoning Specious?

However, this "gross abdication of responsibility"[166] over the last nineteen years has led to the realization that there are clearly "situations where vertical mergers and other vertical restraints can raise significant competitive concerns."[167] This new school of thought is known as the Post-Chicago School, and although it does not suggest a return to a per se prohibition of vertical mergers, it suggests that such mergers be evaluated and enforced on a case-by-case basis to determine if they will have an unreasonable anti-competitive effect.[168] Essentially, its critique of the Chicago School is based on the "[observation] that Chicago style theories of competitive robustness were based on overly simplistic market assumptions, including fixed proportions, good information, and relatively easy entry."[169] However, the truth remains that "anticompetitive strategic behavior becomes much more plausible when these assumptions are relaxed."[170]

seriously for the first time the nature of capital and the historical development of industry and commerce).

[166] Riordan & Salop, *supra* note 163, at 514 (quoting Letter from Jack Brooks, Chairperson of the House Judiciary Committee, to DOJ Assistant Attorney General Anne Bingaman and FTC Chairperson Janet Steiger (Nov. 4, 1993)).

[167] *Id.* at 515.

[168] *See* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 283–89, 329–49 (1994) [hereinafter HOVENKAMP, FEDERAL ANTITRUST POLICY]; Jonathan B. Baker, *Recent Developments in Economics That Challenge Chicago School Views*, 58 ANTITRUST L.J. 645 (1989); Oliver Hart & Jean Tirole, *Vertical Integration and Market Foreclosure*, *in* BROOKINGS PAPERS ON ECONOMIC ACTIVITY, MICROECONOMICS 205 (1990); Eleanor M. Fox & Lawrence A. Sullivan, *Antitrust—Retrospective and Prospective: Where Are We Coming from? Where Are We Going?*, 62 N.Y.U. L. REV. 936 (1987); Herbert Hovenkamp, *Post-Chicago Antitrust: A Review and Critique*, 2001 COLUM. BUS. L. REV. 257 (2001) [hereinafter Hovenkamp, *Post-Chicago Antitrust*]; Louis Kaplow, *Extension of Monopoly Power Through Leverage*, 85 COLUM. L. REV. 515 (1985); Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209, 230 (1986); Janusz A. Ordover et al., *Equilibrium Vertical Foreclosure*, 80 AM. ECON. REV. 127 (1990); Patrick Rey & Jean Tirole, *The Logic of Vertical Restraints*, 76 AM. ECON. REV. 921 (1986); Riordan & Salop, *supra* note 163; Lawrence A. Sullivan, *Post-Chicago Economics: Economists, Lawyers, Judges, and Enforcement Officials in a Less Determinate Theoretical World*, 63 ANTITRUST L.J. 669 (1995); White, *supra* note 164.

[169] See Hovenkamp, *Post-Chicago Antitrust*, *supra* note 168.

[170] *Id.*

The Federal Trade Commission (FTC) and Department of Justice (DOJ) share responsibility for enforcing antitrust law.[171] However, because of their overlapping authority, the two departments often clash over who will handle particular mergers.[172] This process is not subject to public scrutiny and slows down by several days the time in which mergers are approved.[173] Consequently, the FTC ceded oversight of media and entertainment industry mergers to the DOJ in an effort to speed up the clearance process.[174] Thereafter, entertainment industry mergers ran virtually unchecked, totaling an unprecedented 362 mergers and acquisitions worth $49.4 billion in the year 2000.[175] Senator Fritz Hollings, then chairperson of the Senate Appropriations subcommittee and chair of the Senate Commerce Committee, called the FTC's practice "illegal" and threatened FTC Chairperson Tim Muris with slashing the FTC's budget and worker salaries in order to "get their full attention."[176] The Republican-led FCC had even gone so far as to file a formal appeal, demanding that the recent deregulation of media conglomerates be reversed,[177] but with the recent appointment of Senator McCain and the Republican takeover of the Senate, the

[171] *See* Brooks Boliek, *FTC Faces Holling's Wrath over DOJ's Merger Control*, HOLLYWOOD REP., Mar. 20, 2002, at 1, 36.
[172] *See id.*
[173] *See id.*
[174] *See id.*
[175] *See Year 2000 Media Industry M&A*, CLIENT BRIEFING (The Jordan, Edmiston Group, Inc., New York, N.Y.), Jan./Feb. 2001, http://www.jegi.com/pdf/Jan-Feb%202001.pdf.
[176] Boliek, *supra* note 171, at 1. Muris defended the deal, claiming that the clearance process had become too "confrontational and fractious" and that this would allow antitrust officials to do their job more efficiently. His reasoning is both specious and suspect. It is specious because the delay is only a few days in a process that can take several months, and it is suspect because the decision was partially based upon advice from an outside consultant, Joe Sims, who represents AOL-Time Warner. Hollings noted the conflict of interest to which Sims responded, "I don't buy that argument. It obviously makes no difference to me in my practice if it's the FTC or DOJ. I get paid whichever way it goes." *Id.* at 36. Hollings, obviously flustered, stated "[t]his administration is running amok." *Id.*
[177] *See* Pamela McClintock, *FCC Appeals Media Ruling*, DAILY VARIETY, Apr. 22, 2002, at 1, 17.

threat of a budget slash by the Senate Appropriations Committee was neutralized.[178]

Senator Holling's argument is persuasive, since although more voices can be heard, those voices are owned by fewer corporations. In a chilling parallel to the conditions which gave rise to the 1948 divestiture of film studios from exhibition,[179] media ownership has currently been reduced to essentially seven major corporations—only this time they have even more reach.[180]

For example, in 1995, the American Broadcast Company merged with the Walt Disney Corporation in a $19 billion dollar deal to become ABC-Disney.[181] In December 2000, Vivendi-Seagram-Canal+ became Vivendi-Universal in a merger valued at $34 billion.[182] Then, in 2001, AOL-Time Warner followed suit, becoming the largest media giant in a merger valued at $106 billion.[183]

[178] *See* Brooks Boliek, *Regs Rewrite on Fast Track: Senate Power Shift Makes Ownership Rules Top Priority*, HOLLYWOOD REP., Nov. 7, 2002, at 1.
[179] *See* United States v. Paramount Pictures, Inc., 334 U.S. 131 (1948).
[180] *See supra* note 13.
[181] This $19 billion merger was completed in August 1995, and by the end of the week their combined value reached $48 billion. *See* Nancy Gibbs, *Easy As ABC: In One Megadeal, Eisner Turns His Magic Kingdom into a Global Empire and Takes His Sweet Revenge on a Choir of Critics*, TIME, Aug. 14, 1995, at 24.
[182] This $34 billion merger was created in December 2000 based on an agreement announced June 20, 2000. It incorporated Universal Pictures and Universal Music Group, then owned by Seagram, and gave the media giant control over 9,000 films, 27,000 television episodes, and 750,000 songs. It includes a forty-two percent equity stake in USA Networks, which includes the Sci-Fi Channel, the Home Shopping Network, TicketMaster, the Hotel Reservations Network, Gramercy Pictures, and October Films. *See* Lori Enos, *Vivendi, Seagram and Canal+ to Merge*, E-Commerce Times, *at* http://www.ecommercetimes.com/perl/story/3601.html (June 20, 2000). It also includes companies in the areas of film, Internet, music, television, publishing, and telecoms including, inter alia, MCA, Polygram, Island/Def Jam, Motown, Geffen, Interscope, and Rising Tide records; United International and Cinema International BV pictures; VivendiNet, Vizzavi, and Universal Studios New Media Group Internet services; Multimedia and Brillstein-Grey television entertainment; Havas Press publishing; and Cegetel and Vivendi telecom for telecom services. *See Frontline: The Merchants of Cool: Media Giants: Vivendi Universal*, *at* http://www.pbs.org/wgbh/pages/frontline/shows/cool/giants/vivendi.html (last visited Feb. 21, 2003).
[183] This $106 billion merger was completed January 11, 2001, giving the combined media and Internet giant a $205 billion market capitalization. *See* Patrick Ross & Evan Hansen, *AOL, Time Warner Complete Merger with FCC Blessing*, CNet News, *at* http://www.news.com.com/2100-1023-250781.html?legacy=cnet (Jan. 11, 2001).

These media giants have major holdings in the six principal media areas: theatrical film, television, cable, telecom, music, and video. Without even so much as a national media restriction, these few companies now control both the news and entertainment media—under the tacit approval of the executive, legislative and judicial bodies—in order to influence our perceptions of world events and the content through which we enjoy our free time.

The net effect of these mergers is that the "little guys" are being drowned out by the "noise" of too many voices; or *insignificant* because they will not have the advertising budget with which to capture the attention of the billion or so netizens projected to be using the world wide web by 2006.[184]

For independent film producers, this will likely mean that there is no real point of entry, and Internet distribution is not likely to cure this problem. Independent producers will not be able to rent their films effectively over the Internet unless they do so through large film companies that have the power to collect revenues, the visibility to attract consumers, and the wealth to maintain reliable servers from which consumers can download the videos.

The studios' reasoning is therefore specious, because the net result of these mergers is an unprecedented anti-competitive effect. There will be decreased competition because, in effect, the studios will once again control all video distribution worldwide, and the independent producer/distributor's share will be next to nothing.

The most dramatic testament to the effectiveness of the studios to eliminate competition with respect to Internet distribution thus far has been the low-profile failure of Intertainer, the first attempt at establishing an online video rental outlet.[185] Intertainer, which was launched in 2001, and forced to license its premier films from the film studios, failed after less than a year, garnering only 147,000 customers and spending nearly all of its $125 million in venture capital.[186] Although Intertainer clearly had problems licensing quality films, and although some critics charge that its failure was also due to imperfect streaming and a $7.95 per month

[184] *See Internet User Forecast by Country*, *supra* note 1 and accompanying text.
[185] *See* Fritz, *supra* note 74.
[186] *See id.*

subscription fee, it is worth noting that Intertainer is currently suing the studios for anti-competitive behavior.[187] Moreover, the agreement between the five studios comprising Movielink to establish fixed rental prices[188] may very well lead to a lawsuit similar to one recently filed by the states against the recording industry, which resulted in a $143 million settlement.[189]

IV. HOW PIRACY MAY AFFECT PROFIT PARTICIPANTS

Traditionally, studios have exploited both domestic (including both the U.S. and Canada) and foreign home video markets by physically shipping videos to content aggregators. This method was inordinately expensive. It costs approximately three dollars to make each video cassette,[190] excluding the cost of shipping (airfreight or ground), allowances for damage and piracy, and the vast infrastructure required to support such a labor intensive model (including, but not limited to, unions, product tracking, and independent auditing of sales agents). The U.S. film industry earns $7.5 billion annually from worldwide distribution.[191] Video distribution accounts for approximately forty percent of this total, or $3 billion.[192] However, these gross revenues are often offset by losses to video piracy.

[187] *See Slate Sidebar*, *at* http://slate.msn.com/?id=2073743&sidebar=2073744 (last visited Feb. 8, 2003) (stating that the lawsuit may be "little more than a last-ditch effort to recoup some cash for investors who bought into a failed Internet business").

[188] *See Risky Business? New On-Demand Digital Movies May Not Be Pirate Proof*, *supra* note 75 (in which the five studios comprising Movielink announce that they have settled on a rental price of approximately $3.99 per film).

[189] *See* Tamara Conniff, *CD Price-Fixing Suit Settled: Labels, Chains to Compensate States to Tune of $143 Mil*, HOLLYWOOD REP., Oct. 1–7, 2002, at 1, 91.

[190] This includes the cost of the cassette, billing block stickers, cassette cases, and key art. Key art is generally created for the theatrical advertising campaign, and billed as a "theatrical distribution expense." Later, this art is often re-used on video cassettes, and the cost is charged again, only now it is billed as a "video distribution expense." *See* DANIELS ET AL., *supra* note 9, at 65.

[191] *See 'Angels' Take the Cake in Big-Screen Debut*, CNN, *at* http://www.cnn.com/2000/SHOWBIZ/Movies/11/05/box.office.ap (Nov. 5, 2000).

[192] *See* Universal City Studios, Inc. v. Reimerdes, 111 F. Supp. 2d 294, 311 (S.D.N.Y. 2000), *aff'd sub nom.* Universal City Studios, Inc. v. Corley, 273 F.3d 429 (2d Cir. 2001).

A. On-Line Piracy: The Sum of All Fears

The greatest perceived loss from Internet video distribution is piracy.[193] As reported in Daily Variety, bootleg copies of films on video, DVD, and VCD cost Hollywood an aggregate total of $1.2 billion in lost revenues in 2001[194] the equivalent of one-third of the entire revenue generated from video distribution worldwide Moreover, losses in the United States account for $250 million, or one-twelfth, of that total.[195]

Under the old model, where videos were physically shipped to foreign markets, the threat of piracy was significant, yet limited by language,[196] incompatible formats,[197] and the cost of maintaining a piracy ring, which was nearly impossible to do on a global scale. The Internet, however, threatens to erase each of these limitations.

When video is released on the Internet, anyone at anytime will be able to download a video if a pirate supplies him or her with a decryption code. Additionally, unencrypted videos could be swapped peer-to-peer,[198] in effect creating a "Napster for Movies"[199] that could virtually eliminate the video market for a

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[193] *See* McClintock, *supra* note 3, at A9.

[194] *See id.* (figures broken down as follows: U.S. ($250 million), Russia ($250 million), China ($160 million), Italy ($140 million), Brazil ($120 million), India ($70 million), Germany ($70 million), Mexico ($50 million), France ($50 million), and Turkey ($50 million)).

[195] *See id.*

[196] Films are either dubbed (a voice over is done by a native speaker in the local language and the words are synched, as well as possible, to the actor's lip movement) or subtitled (the text of the actor's speech is translated into the local language and placed at the bottom of the screen for the audience to read as the film plays, but the actor's words remain in the original language of the country producing the film).

[197] Worldwide video standards include U.S.: NTSC (National Television System Committee, 525 lines per frame); Europe: PAL (Phase Alternating Line, 625 lines per frame); France: SECAM (Sequential Color with Memory, 625 lines per frame). *See What Is Standards Conversion*, 3D Research Video, *at* http://www.3dresearch.com/video/Conversion2.html (last visited Feb. 8, 2003).

[198] *See* A&M Records, Inc. v. Napster, Inc., 239 F.3d 1004, 1012 (9th Cir. 2001), *aff'd*, 284 F.3d 1091 (9th Cir. 2002); Fonovisa, Inc. v. Napster, Inc., No. 3:01-CV-02669, 2002 WL 398676, at *7 (N.D. Cal. Jan. 28, 2002), Classicberry Ltd. v. Musicmaker.Com, Inc., No. 01-CV-1756, 2001 WL 1658241, at *2 n.1 (S.D.N.Y. Dec. 26, 2001), *aff'd*, No. 02-CV-7054, 2002 WL 31313186 (2d Cir. Oct. 16, 2002).

[199] *See* A&M Records, Inc. v. Napster, Inc., 284 F.3d 1091 (9th Cir. 2002) (the final *Napster* decision); David Iler, *Pirate-Proofing On-Demand Content*, COMMUNICATIONS

film overnight. Compared with the projected losses from Internet video distribution, therefore, the traditional loss figures for piracy will be child's play.

Certainly, studios will seek to prevent Internet piracy.[200] Senator Joseph Biden, Jr., D-Delaware, chair of the foreign relations panel, stated "[n]ot to protect it is equivalent to letting coal be stolen from our mines or water taken from our rivers . . . [but] how will we preserve the creativity and experimentation that are America's inexhaustible oil wells?"[201] Senator Biden touches on perhaps the greatest problem facing Internet distribution: the perceived notion that a "perfect copy" of a current film released as a rental, or an older film released to meet the standards of high-definition television (HDTV), will completely exhaust the studios' film libraries.[202] If past experience with music[203] and video[204] piracy is any indication, this is a well-founded fear. However, much to the consternation of film studio executives, recognizing the problem does not necessarily lead to a solution.

Piracy issues can be broken down into two areas: prevention and enforcement.

ENGINEERING & DESIGN, Feb. 2, 2002 (expressing the fear of unrestricted video swapping), http://www.cedmagazine.com/ced/2002/0202/id4.htm; Reuters, *supra* note 66.

[200] *See* Universal City Studios, Inc. v. Reimerdes, 111 F. Supp. 2d 294, 333, 340 (S.D.N.Y. 2000), *aff'd sub nom.* Universal City Studios, Inc. v. Corley, 273 F.3d 429 (2d Cir. 2001); David Iler, *supra* note 199 (providing an excellent analysis of how studios plan to encrypt videos distributed via broadband Internet).

[201] McClintock, *supra* note 3, at A9.

[202] *See id.*

[203] *See* Ray Bennett, *Music Hits Worldwide Sour Note*, HOLLYWOOD REP., Apr. 17, 2002, at 5, 48 (stating that according to figures released by the International Federation of the Phonographic Industry, the worldwide record industry fell five percent in 2001 because of increased piracy).

[204] *See* Bob Sullivan, *Net Pirates Poach Harry Potter Film: Film Copied with DV Camera, Posted in Chat Rooms*, MSNBC, *at* http://www.msnbc.com/news/834107.asp (Nov. 13, 2002) ("[O]ne million fans had watched illegal copies of 'Star Wars: Attack of the Clones' over the Internet before it was released in May [2002], and that about two million people in the United States regularly try to download pirated video." Furthermore, the web site vcdquality.com is exclusively dedicated to rating the quality of pirated films and gives clear indications as to how to locate such films online.).

1. Preventing Piracy

In order to prevent piracy, the studios have argued for—and received—high levels of encryption technology.[205] Setting a high-level encryption standard is a relatively simple issue, since it can be achieved by passing legislation through Congress by an extremely powerful lobbyist, the film industry. Even so, setting a stringent encryption standard will not make a downloaded video theft-proof, because digital pirates often copy films directly off the screen with digital cameras.[206] Although film studios now tag their pre-screening films with near-invisible identifiers to determine where the copies were made,[207] there have been no resulting convictions.

Additionally, as *Universal City Studios, Inc. v. Reimerdes* amply illustrates, security systems are vulnerable at the source.[208] In *Reimerdes*, the DVD Content Scrambling System (DeCSS) encryption used to protect copyrighted works on DVD was broken by a fifteen-year-old "sleuth" who received an unencrypted DVD disc because of a factory slip-up.[209] In digital video distribution, it is more likely that the encryption code studios use to protect the video will be circumvented by an inside job. In such a scenario, a trusted studio agent copies an unencrypted video and delivers it to pirates who distribute it to the public. For example, James Cofer, a trusted security vault manager, was convicted of bribing security vault guards for access to the unreleased films *Armageddon, Fantasia 2000*, and *Mighty Joe Young*, in order to duplicate the videos and sell them on the Internet.[210] The court fined Cofer

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205 *See* McClintock, *supra* note 3, at A9 (Jack Valenti, President and CEO of the Motion Picture Association of America [MPAA], lobbied Capitol Hill, threatening that as long as studios did not receive assurances that films would have adequate copyright protection technology, studios would refuse to open their libraries for Internet distribution).

206 *See* Sullivan, *supra* note 204 (stating that by using digital video cameras mounted on tripods in conjunction with handicapped seating that offers headphones for enhanced hearing, pirates are able to create near-perfect digital reproductions from theater screens and then post the films to the Internet).

207 *See id.*

208 *See* Universal City Studios, Inc. v. Reimerdes, 111 F. Supp. 2d 294 (S.D.N.Y. 2000), *aff'd sub nom.* Universal City Studios, Inc. v. Corley, 273 F.3d 429 (2d Cir. 2001).

209 *See id.*

210 *See Legal Briefs,* HOLLYWOOD REP., Oct. 20–22, 2000, at 22.

$1,450, sentenced him to sixty days on a work crew, and placed him on three years' probation for his trade secret violation. His co-defendant, Gerhard, was sentenced to either 120 days in jail or 60 days on a work crew, and fined $10,900.[211]

Clearly, encryption is the first line of defense and the studios' best method for preventing piracy. On Capitol Hill, the battle rages on as opposing parties attempt to strike a balance between privatized gain and socialized loss.[212] Proponents argue for stronger encryption to protect copyrighted works and to ensure a maximum return on profits.[213] Opponents, however, argue that such restrictions violate free speech and the fair use doctrine of the Copyright Act, and that the anti-circumvention provisions of the Digital Millennium Copyright Act (DMCA) amount to copyright misuse by conferring a greater monopoly than was intended by Congress.[214] Others have argued that DMCA's penalties violate the Eighth Amendment.[215]

This dispute is fomenting and bitterly pits the nation's largest computer and software producers against Hollywood studios. The computer companies[216] decry government intervention, calling the

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211 *See id.*

212 *See* McClintock, *supra* note 3.

213 *See Universal City Studios*, 111 F. Supp. 2d at 294.

214 *See* U.S. CONST. art. I, § 8, cl. 8.

215 *See* Robert Lemos, *Protesters Declare War on Copyright Law*, CNet News, *at* http://news.com.com/2100-1023-272415.html (Aug. 30, 2001) (Lawrence Lessig, director of Stanford University's Center for Internet and Society, railed against the Digital Millennium Copyright Act [DMCA] in what he called "the beginning of a revolution" at a legal defense fundraiser in the wake of the arrest and sentencing of Alexander Katalov, the president of Elcon, and Dmitry Sklyarov, for trafficking in a program designed to circumvent copyright protection for eBooks so that copies could be made and freely distributed among Internet users. Both pled guilty to five criminal counts, which could impose a penalty of up to $2.5 million in damages and twenty-five years in prison.).

216 The alliance that has been forged in order to prevent government imposed encryption controls includes the RIAA, the Business Software Alliance (comprised, inter alia, of Microsoft, Apple, Adobe, Symantec, Autodesk, and Macromedia), the Computer Systems Policy Project (comprised of the CEOs from, inter alia, Dell, Hewlett-Packard, IBM, Intel, and Unisys), as well as various consumer groups. *See* Brooks Boliek, *High-Tech Group Targets H'wood: Coalition Seeks to Curtail Copyright Controls on Digital Devices*, HOLLYWOOD REP., Jan. 24–26, 2003, at 4, 51; Associated Press, *Net Music Copyright Deal Reached: Recording Industry, Tech Firms Negotiate Compromise*, MSNBC, *at* http://www.msnbc.com/news/859079.asp (Jan. 14, 2003). *See also* Computer

motion picture industry "the enemy" and claiming that encryption and "locking controls" placed on personal computers will allow the government to "lobotomiz[e] our laptops."[217] Hollywood, on the other hand, has become politically isolated because of its aggressive support for copyright protection that would "prohibit the manufacture and distribution of 'digital media devices'—such as handheld music players—unless they include government-approved copy restriction technology."[218] Although Congress has thus far legislated in favor of stronger and longer copyright protection,[219] past regulations were instituted under Democratic leadership. Therefore, if the present Republican majority in the House and Senate, coupled with Silicon Valley's seven-figure lobbying budget, is any indication, Hollywood will have a tough battle ahead.[220]

2. Enforcement and Collecting Judgments

Enforcement and collecting judgments are entirely different matters, each requiring expensive lawyers, the power of the U.S. court system (which can be slow and unpredictable), and cooperation from foreign governments who are often unconcerned with, or indifferent to, American companies' need to secure profits.[221] One of the greatest problems with enforcement is that piracy presents a constantly moving target.

Systems Policy Project, *at* http://www.cspp.org (last visited Mar. 7, 2003); *BSA Members*, Business Software Association, *at* http://www.bsa.org/usa/about/members (last visited Mar. 7, 2003).

217 Boliek, *supra* note 216, at 4, 51 (quoting Fred McClure, President of the Alliance for Digital Progress).

218 Associated Press, *supra* note 216 (quoting Senator Ernest Hollings).

219 *See* Commerce and Foreign Trade, 15 C.F.R. pt. 734, Supp. 1 (2000) (U.S. Export Administration Regulations). *See also* Eldred v. Ashcroft, 123 S. Ct. 769 (2003).

220 *See* Boliek, *supra* note 216, at 4, 51 (describing MPAA President Jack Valenti's challenge to Fred McClure to engage in a public debate with respect to this issue).

221 *See* Cathy Dunkley, *Windows of Opportunity: Release Patterns Are Collapsing Around the World and It's Making the World Seem Smaller*, HOLLYWOOD REP., Oct. 10–16, 2000, at 18.

B. Who Are Targets of Piracy? Industrial Age v. Information Age Big Business, Not the Problem

Traditionally, the bigger the target, the easier it is to prevent piracy. A larger target is easier to locate, easier to prosecute, and easier to collect judgments from. This was true in the Industrial Age, when hard copies (videocassettes) were piracy targets. If a pirate could obtain an unprotected video, or circumvent both copyright protection and encryption software, then the pirate could make and sell tape duplications. In 2000, the entertainment industry claimed a $35 million dollar loss in domestic video revenue because of tape piracy, leading to an overall downturn of seventy percent in gross proceeds when corrected for inflation.[222] This form of piracy was also particularly popular abroad, leading to losses of more than $950 million in 2001.[223]

For physical distribution of a tangible product, however, pirates require a large operation: they need tape duplication machines, they have to purchase tapes, make "knock off" key art versions for video sleeves, secure warehouses to store the tapes, and ship the pirated tapes to consumers. All of this requires money, time, and facilities.

Consequently, for physical copies, the economies of scale support pirates having larger operations, because the larger they are, the more efficient their operation will be. Therefore, under the traditional model, pirates, although harmful, were more easily controlled because they were bigger targets and easier to find.

Enforcement of Internet distribution is also geared to catching large-scale operations. For example, the DMCA has "notice and takedown" provisions, which require any entity accused of copyright infringement to effectively cease and desist

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[222] *See id.* at 18–19 (discussing the burdens and benefits of simultaneous verses staggered release patterns and the possible effect on overall net revenue for film studios).

[223] *See* McClintock, *supra* note 3; text accompanying note 195. *See also* Matthew Brzezinski, *Stopping Russian Theft Is Nyet Easy*, DAILY VARIETY, Mar. 4, 2002, at A1; Jeremy Hansen, *H.K. (Hong Kong) Chops Piracy: Customs Official Reports 98% Curtailment*, DAILY VARIETY, Oct. 4, 2000, at 9; Tessa Jazmines, *Philippine Talent Asks for Help*, DAILY VARIETY, Mar. 4, 2002, at A10; Scott Rosenberg, *Thai Retailers Busted for Illegal Goods*, DAILY VARIETY, Mar. 4, 2002, at A10.

operations.[224] Furthermore, since entities must register with an online service provider, they will be easier to track and less likely to be able to maintain a sustained effort.[225]

1. What About the Little Guys?

In the Information Age, however, individuals present the greatest threat. This is probably the single most frightening aspect of modern piracy to copyright holders. With the proper decryption devices, anyone, anywhere, anytime can obtain a pirated copy of protected material.[226]

In 2000, the Motion Picture Association of America (MPAA) began to aggressively pursue individual pirates and hired Ranger Online, a Canadian company that patrols the Internet by sending out "take down" notices[227] to Internet service providers and individual users in multiple countries and in multiple languages.[228] For independent films, the American Film Marketing Association is the principal enforcement body, and it also employs Ranger Online, as well as another search engine.[229] In 2001, approximately 54,000 warning notices were sent to individuals

[224] *See* 17 U.S.C. § 512(c)(3)(A) (2000); ALS Scan, Inc. v. RemarQ Communities, Inc., 239 F.3d 619, 625 (4th Cir. 2001).

[225] *See* McClintock, *supra* note 3.

[226] *See* David Clark, *Encryption Advances to Meet Internet Challenges*, Computer, *at* http://www.computer.org/computer/articles/August/technews800.htm (last visited Feb. 8, 2003) (noting that the time to break encryption ranges from 10^4 years in millions of instructions per second (MIPS) for RSA/DSA key size of 512 to 10^{38} years for RSA/DSA key size of 21,000) (Author's note: This does *not* mean it takes 1000 years to break an encryption of 512; this time is greatly accelerated by larger computers, such as the Kray computer, or by placing slower computers in serial phase so that they can process the instructions simultaneously. In this instance, breaking a 512 encryption would take less than one month).

[227] *See Ranger Client Testimonials*, Ranger Library, *at* http://www.rangerinc.com/Library/6-1.shtml (last visited Apr. 16, 2003) ("Ranger has developed a custom search engine and an automated system for sending out "take down" notices asking Internet service providers to notify a particular customer of the violation and these notices can also can go directly to Internet users.").

[228] *See* McClintock, *supra* note 3, at A9–A10.

[229] *See id.* at A10.

downloading films from the Internet, a number that is projected to double in 2002.[230]

Ranger Online (hereinafter "Ranger") works in the following way: (1) studios or independent producers—"indies"—submit a list of titles to Ranger; (2) Ranger searches Internet chat rooms and sites from which these titles can be downloaded, (3) the MPAA issues "warning notices" based on the search results, and (4) with very few exceptions, the piracy stops.[231] In 2001, there were only two challenges to the 54,000 warnings issued.[232] For the most part, this success is attributable to the fact that the persons targeted are not generally considered to be criminals, so a simple warning will suffice.[233]

C. How, and Where, Can the Pirates Be Stopped?

1. Domestic Jurisdiction

Previously, it was thought that "[c]racking down on piracy in the United States is relatively straightforward when it comes to legal authority,"[234] because, under recent copyright law, anyone who downloads and hosts a protected file on a home computer faces federal prosecution regardless of whether he or she seeks financial gain.[235]

In the past, media companies have successfully prosecuted: (1) a fifteen-year-old hacker who cracked DeCSS;[236] (2) a Princeton computer science professor who wanted to post a decryption

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[230] *See id.* at A9 (the 54,000 bearing a 2001 postmark were distributed as follows: U.S. (36,000); Europe, Middle East, and Africa (9,000); Canada (7,000); and Latin America (89)). This author notes as significant that the problem is much greater in Latin America than the numbers convey, perhaps because the program utilized by Ranger Online only recently became able to search in multiple languages.

[231] *See id.* at A10.

[232] *See id.*

[233] *See id.*

[234] *Id.*

[235] *See* 17 U.S.C. § 1201 (2000) (the Digital Millennium Copyright Act's anti-circumvention provision); Jason Hoppin, *The Crackdown on IP Crime*, RECORDER, Dec. 3, 2001, http://www.law.com/regionals/ca/stories/edt1203a.shtml.

[236] *See* Universal City Studios, Inc. v. Reimerdes, 111 F. Supp. 2d 294 (S.D.N.Y. 2000), *aff'd sub nom.* Universal City Studios, Inc. v. Corley, 273 F.3d 429 (2d Cir. 2001).

algorithm on the web,[237] and (3) random college students downloading pirated videos from the web.[238] However, recent case law has called into doubt the effectiveness of legal authorities to prosecute such copyright crimes. Most recently, in November 2002, the California Supreme Court ruled that the real party in interest, the California based DVD Copy Control Association, could not sue a Texas resident in California for posting DeCSS on the Internet.[239] This ruling was based on the majority's holding that the defendant, Matthew Pavlovich, did not have sufficient minimum contacts with the forum state.[240] Therefore, allowing the suit to proceed in California would have been tantamount to allowing all plaintiffs connected to the auto industry to sue defendants in Michigan merely because the industry is based there.[241] In light of the "effects test" set forth in *Calder v. Jones*,[242] the future legitimacy of this ruling will likely be called into question and the exercise of personal jurisdiction over future defendants will likely turn upon the defendant's intent.

2. Foreign Jurisdiction

Enforcement in foreign jurisdictions presents a much greater problem. First, enforcement in this context is more a matter of

[237] *See* Hoppin, *supra* note 235. The music industry challenged Prof. Felten to crack its proposed CD protection. Felten succeeded, and when he wanted to present his findings, the RIAA threatened to sue him. *Id.* He sued for declaratory relief in order to present his findings and lost. *See* Final Hearing Transcript, Felten v. Recording Indus., (D.N.J 2001) (01-CV-2669), http://www.eff.org/Legal/Cases/Felten_v_RIAA/20011128_hearing_transcript.html.

[238] *See* Hoppin, *supra* note 235 (discussing how Jason Spatafore was arrested by the U.S. Attorney's office and placed on two years probation for downloading a pirated copy of STAR WARS: EPISODE I—THE PHANTOM MENACE (Twentieth Century Fox 1999), splitting it into several smaller files and reposting it on his own web site). In this case, the government had no trouble haling the defendant into court in California despite his status as a citizen of Arizona and despite his claims that he did not know he was breaking the law. *Id.*

[239] *See* Pavlovich v. Super. Ct., 58 P.3d 2 (Cal. 2002).

[240] *See id.* at 11–12 (noting that Pavlovich's sole contact with California was his company's Internet web posting; Pavolvich did not live, work, own property, transact, or direct his business activity toward California).

[241] *See id.* at 13; Chris Marlowe, *Antipiracy Ruling Sets Precedent: California's Supreme Court Tackles Jurisdiction Question*, HOLLYWOOD REP., Nov. 27, 2002, at 3, 18.

[242] 465 U.S. 783 (1984).

political negotiation than law. Therefore, to help combat international video piracy, the MPAA has set up an extra-judicial worldwide Internet enforcement group.[243] This group consults with a former U.S. Department of Justice attorney who is well-versed in computer crime, and lobbies the U.S. trade representative to help "make sure trading nations are doing their part tracking down and prosecuting pirates."[244] Additionally, the MPAA is "pushing legislation that would give President Bush authority to strike trading treaties without getting prior approval from Congress."[245] Whether this approach will be more or less successful than enforcing traditional court orders through treaty signatories remains to be seen.

D. Keeping Score: Recent Successes and Failures

At present, the anti-piracy landscape resembles a battlefield, with casualties on both sides. On the domestic front, although Adobe had already prevailed in its civil suit,[246] a jury in the United

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243 *See* McClintock, *supra* note 3, at A10.

244 *Id.*

245 *Id.*

246 Adobe Systems successfully prosecuted the Russian software company, Elcomsoft, for publishing software that converts copy-protected eBooks into postscript document format [PDF] documents which can easily be printed, copied, and distributed by Internet users, despite the fact that the software had legitimate uses. Adobe's fear was that the Advanced eBook Processor (which removes restrictions on reading and printing from encrypted PDF files) would be used to make illegal copies of eBooks, which could be distributed through "Napster-like" file sharing networks. Adobe's Anti-Piracy Division forced Elcomsoft to remove its web site from the Internet, and stop selling the product from RegNow (a division of Digital River). *See Adobe and the eBook Pirates: Adobe Threatens Software Developer over eBook Conversion Software*, *at* http://publishing.about.com/library/weekly/aa070501a. htm (last visited Feb. 8, 2003).

The feds later arrested Elcomsoft's security expert, Dimitry Sklyarov, at Defcon, the annual hacker's convention in Las Vegas, after he delivered his presentation, *eBook Security: Theory and Practice*, which outlined the shortcomings of eBook security. The basis for the arrest were alleged violations of the DMCA. *See* John Leyden, *eBook Security Debunker Arrested by Feds*, Register, *at* http://www.theregister.co.uk/content/55/20444.html (July 17, 2001).

Mr. Sklyarov's arrest sparked mass protests by free speech advocates, such as the Electronic Frontier Foundation [EFF], which quickly became a public relations disaster for Adobe. Adobe dropped all charges against Mr. Sklyarov in July 2001, and the Department of Justice dropped criminal charges in December 2001 in exchange for his testimony against his employer, ElcomSoft. *See* Hoppin, *supra* note 235.

States District Court for the Northern District of California acquitted Russian software firm Elcomsoft of criminal charges of violating the DMCA by selling a $99 program that allowed users to make copies of eBooks[247] that had been digitally encrypted.[248] In January 2003, however, the United States District Court for the District of Columbia handed a victory to copyright holders by ruling that a subpoena on Internet web service provider Verizon to reveal the names of their customers who are allegedly liable for copyright infringement was constitutionally enforceable under the DMCA.[249]

Internationally, courts have been equally divided. On January 7, 2003, in a unanimous twenty-five-page ruling, the Oslo City Court in Norway acquitted defendant Jon Lech Johansen of creating a program to crack the DeCSS so that he could play a DVD on his Linux-based computer.[250] Interestingly, the case was prosecuted as a data break-in rather than as a copyright violation, leading Johansen to defend his act of circumvention by stating that "[a]s long as you have purchased a DVD legally, then you are

[247] An eBook is simply a downloadable version of a book that can be read on handheld devices and personal computers. *See eBooks*, Paradigm Red Shift, *at* http://www.paradigm-redshift.com/ebooks.htm (last visited Feb. 9, 2003).

[248] *See* United States v. Elcom Ltd., 203 F. Supp. 2d 1111 (N.D. Cal. 2002). *See also* Associated Press, *IT Firm Cleared in Copyright Case*, Sci-Tech, *at* http://news.ninemsn.com.au/Sci_Tech/story_44118.asp (Dec. 23, 2002) (stating that Elcomsoft could have been fined $2 million plus penalties if willfulness had been proven); Reuters, *Russian Firm Cleared in U.S. Digital Copyright Trial*, CNet News, *at* http://news.cnet.com/investor/news/newsitem/0-9900-1028-20758904-0.html (Dec. 17, 2002) ("We accept the jury's verdict. . . . While disappointed, we are also pleased the judge upheld the constitutionality of the [DMCA] and the jurisdiction of the United States to bring these cases." (quoting Kevin Ryan, U.S. Attorney for the Northern District of California)); Paul Sweeting, *Acquittal in C'right Trial*, DAILY VARIETY, Dec. 20, 2002, at 24 (stating that the MPAA and Adobe had declined to comment on the verdict); *Russian Firm Innocent in Copyright Case*, United Press International, *at* http://www.upi.com/view.cfm?StoryID=20021217-042812-2354r (Dec. 17, 2002) ("Today's jury verdict sends a strong message to federal prosecutors who believe that tool makers should be thrown in jail just because a copyright owner doesn't like the tools they build." (quoting Fred von Lohmann, an intellectual property lawyer with the EFF)).

[249] *See In re* Verizon Internet Servs., Inc., No. 02-CV-0323, 2003 WL 141147, *17 (D.D.C. Jan. 21, 2003); Justin Oppelaar, *Pirates Face Music, Verizon Must Reveal Swappers' ID, Judge Sez*, DAILY VARIETY, Jan. 22, 2003, at 8.

[250] *See* Associated Press, *Teen Acquitted in DVD Hack Case: Norwegian Court Deals Blow to Hollywood's Copyright Fight*, MSNBC, *at* http://www.msnbc.com/news/856102.asp (Jan. 7, 2003).

allowed to decode it with any equipment and can't be forced to buy any specific equipment."[251] Prosecutors have since appealed the ruling.[252] Conversely, on January 23, 2002 in the United Kingdom, the High Court, Chancery Division, held that Sony had established liability for circumventing the DVD CSS under section 296 of the Copyright, Designs and Patents Act 1998, after defendant Edmunds of Channel Technology had imported from Russia and sold the "Messiah" chip, which allows pirated games and pornography to be played on Sony's Playstation 2.[253]

E. Non-Legal Solutions: Establishing a Piracy Equilibrium

Due to the difficulty in tracking down and enforcing judgments in a global environment, the most apt solution is likely to fall outside the legal realm. This solution, based on sound business principles and common sense, is governed by the principle that people will not expend great effort or suffer the threat of legal consequences if they can receive a product at a reasonable price. Therefore, it is necessary for film studios to strike a reasonable balance of interests by reducing prices to the point at which their losses to piracy will be tolerable yet they will still receive a reasonable return on their investment, thus creating a "piracy equilibrium."

The first steps toward a piracy equilibrium have already been established. On November 11, 2002, MGM, Paramount, Sony Pictures Entertainment, Universal, and Warner Bros. launched Movielink as a practical, legal alternative to piracy.[254] The

[251] *Id.*
[252] *See* Associated Press, *Alleged DVD Hacker's Acquittal to Be Appealed*, USA TODAY, *at* http://www.usatoday.com/tech/news/techpolicy/2003-01-20-dvd-appeal_x.htm (Jan. 20, 2003).
[253] *See* Sony Computer Enter. v. Owen, [2002] E.M.L.R. 34, at 744–45 (Ch. 2002).
[254] *See* Marlowe & Bond, *supra* note 72 (in which Josh Bernoff, Forrester Research principal analyst is said to believe that Movielink resulted from "fears of the possible Napsterization of the film industry"); Fritz, *supra* note 74 (stating "Movielink's primary purpose, as some people involved in the project admit, is to demonstrate that the studios are providing a legal alternative for Internet movie pirates."); Sullivan, *supra* note 204 (stating Movielink is "a legal alternative to pirate film downloading"); *Risky Business? New On-Demand Digital Movies May Not Be Pirate Proof*, *supra* note 75 (stating that Movielink's planned encryption technology, high-quality video, and low download fees would help to prevent the e-piracy of such films as LARA CROFT: TOMB RAIDER

purpose was to unify the fight against online piracy, founded on the belief that people would choose to be law-abiding if presented with a reasonable alternative.[255] This realistic approach may help solve the immediate problem of piracy by reducing the incentive for netizens to seek out unauthorized copies. However, establishing a piracy equilibrium and ensuring studios the right and ability to rent their videos directly to the public under the new distribution model does not ensure that Talent will receive equitable treatment. In a typical studio contract, Talent bargains for gross participation and residuals.[256]

F. What Piracy Means for Talent Participants

Piracy presents a threat to both studios and Talent. It undercuts their mutual financial base and threatens the very core of creative productivity protected by the U.S. Constitution.[257]

While this author supports strong encryption and cannot condemn piracy enough,[258] gloomy predictions that piracy will destroy the industry have not come true, even though perfect digital copies of music have been available for over ten years.

Therefore, piracy really presents a threat profit participants because studios will likely treat piracy as a breakage allowance deducted from gross receipts, and pass the loss on to the profit participants. This is especially true if the income is calculated *after* receipts are taken from an inter-company affiliate distributor. If the affiliate distributes the video over the Internet, the affiliate

(Paramount 2001), PLANET OF THE APES (Twentieth Century Fox 2001), and PEARL HARBOR (Touchstone 2001) which occurred within days of their theatrical premieres).

255 *See id.* While encryption technology experts believe the Windows-based format is vulnerable to piracy and that it would be relatively simple to capture the films permanently, Warner Brothers CEO Barry Meyer said in this article that he believes "human nature is not predisposed towards piracy."

256 Gross participations are bargained-for, whereas, if the picture is made by a guild signatory, minimum percentages based on gross profits for *international video* are established by the respective guilds: i.e., the WGA, DGA, and SAG in their respective Minimum Basic Agreements. *See, e.g.*, WGA, *supra* note 17, at 161–71 (1998). *See also* Tulchin, *supra* note 48.

257 *See* U.S. CONST. art. I, § 8, cl. 8.

258 *See* Konrad Gatien, *How Encryption and National Security Will Affect the Future of Digital Film Distribution*, 8 SW. J.L. & TRADE AM. 229 (2001).

will not incur the loss; rather, it will keep its share of rentals and report the loss to the studio. The studio will then write this loss down against the deemed royalty posted to gross receipts that are figured into profit participations. Therefore, this model will t allow the studio to sequester the lion's share of gross receipts in its affiliate, and then write down the royalties it receives from its affiliate by the amount lost to piracy. Again, the risk and the loss will be passed on to those least able to shoulder the burden—the Talent—while the studios will have successfully insulated themselves from harm through superior bargaining power and clever business models.

CONCLUSION

In 2000, the annual cost for the physical distribution of all films worldwide from all studios was $1.5 billion—approximately twenty percent of reported gross revenues. The loss from content aggregator agreements is equally significant.[259] Under the traditional model, studios were forced to continue these debilitating relationships; that is, it was impractical for studios to open their own distribution networks because consumers would demand greater freedom of choice. However, in the Information Age, this concern has vanished. Now, the greatest concerns are quality and speed. Telecom companies, in association with the major motion picture studios, are rushing to solve both problems.[260] Congress has also been proactive in legislating and providing funds to help private companies grapple with change.[261]

Certainly, standards will be set. It won't be long before micro-fast broadband carrying a compressed digital signal will be linked to high definition television in the home. Propelled by strong economic incentives, the movement towards video distribution via

[259] *See* WAYNE LEVIN, MOTION PICTURE PRODUCTION LAW 17 (2002).

[260] *See* Cameron Hurst, *True Video on Demand Is Possible over the Internet . . . Really!*, Home Toys, *at* http://www.hometoys.com/htinews/oct01/articles/uniview/hurst.htm (Oct. 2001).

[261] *See* Broadband Internet Access Act of 2003, H.R. 267, 108th Cong. (2003). *See also* Doug Johnson, *Tech Policy in 2002*, Vision, *at* www.ce.org/publications/vision/2002/aprmayjun/p5.asp?bc=bak&year=2002 (last visited Feb. 8, 2003).

the Internet is powerful. The traditional method of physical distribution required a vast infrastructure and was costly, cumbersome, and remarkably inefficient. Digital video distribution, on the other hand, requires only that the studio maintain enough servers to make their films available to the public I It is therefore potentially much more lucrative.

The awful truth is that "only about 5% of the major studio/distribution deals actually result in the payment of net profits to anyone, regardless of how much money the film makes (that's the best estimate of a profit participation auditor who is out there on the front lines every day, auditing the studio books)."[262] With unprecedented media conglomeration, the current situation puts unequal bargaining power together with an obligation of fairness toward others, and in to the hands of those least likely to exercise it.

This blatant profit-reaping by film studios is similar to the Robber Barons of the late 1800s and early 1900s who President Theodore Roosevelt called the "malefactors of great wealth."[263] These men, C. Vanderbilt, Jay Gould, J.P. Morgan and Jacob Schiff, have been characterized by historians as "masters of trick and deceit," and as "Mephistopheles," men who practiced "pillage, fraud, and distortion."[264] Their flagrant abuse of power led Roosevelt to adopt "a public and political role for the government in antitrust [to] control, curb, and break-up large private concentrations of economic power."[265]

If past behavior is any indication, the studios are likely to continue to act monopolistically, even if the courts have not yet examined, and attorney generals not yet prosecuted their practices under the strict letter of the law. Studios are unlikely to report profits accurately. Instead they will force weaker bargaining parties with legitimate claims into an occasional settlement, rather

262 JOHN W. CONES, THE FEATURE FILM DISTRIBUTION DEAL (1996).

263 J. Bradford DeLong, *Robber Barons*, *at* http://econ161.berkeley.edu/Econ_Articles/carnegie/delong_moscow_paper2.html (Jan. 1, 1998).

264 *Negative Stereotype of the "Robber Baron"*, *at* http://history.sandiego.edu/gen/soc/robber-barons.html (last visited Feb. 8, 2003) (citing MATTHEW JOSEPHSON, THE ROBBER BARONS (1938)).

265 DeLong, *supra* note 263.

than distribute what could be fairly substantial profits to all Talent participants industry-wide.

In conclusion, because it is not in the studios' financial interest to be generous, or to ensure that profits are distributed equitably, both the legislature and the courts must step in to ensure that studios live up to their contractual obligations of good faith and fair dealing. A net profit definition that results in no profit is manifestly unjust, causes unnecessary litigation, wastes judicial resources, and may dry up the Talent pool for the future.[266]

[266] *See* JAMES JAEGER, THE INDEPENDENT PRODUCER'S MANUAL (1998).