

EZRA J. DONER
ATTORNEY-AT-LAW
119 Fifth Avenue, 3rd Floor
New York, NY 10003

Direct Tel: (212)258-2424
Mobile: (917) 209-3700
E-Mail: edoner@donerlaw.com
www.donerlaw.com

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Client Alert: *Napoleon Dynamite* litigation: Pick the Correct Video Royalty

By Ezra Doner*

Participation reporting for certain media and uses can be idiosyncratic.

Multiple Choice Question:

Cult phenomenon *Napoleon Dynamite* generated a phenomenal \$139 million in DVD sales in its first few years of release. What percentage of this amount did distributor Fox Searchlight share with the movie's producers?

- A. 100%
- B. 31%
- C. 12.88%
- D. 10%
- E. zero

For the answer, keep reading.

The Business Context

After a successful theatrical release in June 2004, *Napoleon Dynamite*, a quirky, independent, low budget film, went on to generate a staggering \$139 million in DVD sales *at the distributor level*.

As happens, success became a magnifier for differences of opinion.

Following an audit, in 2011, the movie's producers sued, claiming (among other things) that Searchlight underpaid by \$10 million because the studio applied a wrong DVD royalty rate. At the end of November, however, a judicial referee, in a preliminary round, took the studio's side on this big ticket issue.

What was the correct DVD rate, and what can be learned from the producers' handling of their claim?

Accounting for Home Video

The usual notion of a movie distribution accounting is: there are revenues; there are costs; revenues are credited; costs are debited; and the balance is the "net" – that is, profit.

* Ezra Doner is an entertainment and copyright lawyer who focuses on the film, TV and other content sectors. He has worked both as an in-house business and legal executive and as a private lawyer. He did not represent any of the parties in this case. © Ezra Doner / All Rights Reserved

Whatever the merits of this notion in general, when it comes to DVD and related media, that's not how it usually works.

In DVD accountings, as a rule, not all revenue is credited, and many costs are not debited. Instead, crediting is limited, by contract, to a negotiated percentage of revenue, commonly referred to as the "royalty rate" or, simply, the "royalty". And the distributor absorbs certain ordinary costs, such as duplication and freight, from the revenue that it retains and doesn't credit.

Royalty Rate in this Case

The documentation for Fox Searchlight's distribution of *Napoleon Dynamite* has two royalty rates: 31.66% of revenue from high price sales (sales of so-called "rental priced units"), and 10% from sale of "sell-through" units. Where did one category end and the other begin? In this case, that was a \$10 million question.

From its DVD gross of \$139 million from high price and sell-through combined, Searchlight credited only \$17.9 million to the producers' account as contractually defined revenue. In other words, despite \$139 million in total sales, the accounting statement treated only \$17.9 million as monies in which the producers might share – 12.88% of the true gross. This 12.88%, the effective royalty, was a weighted average, based on a small portion of revenue at 31.66%, and the lion's share of revenue at 10%.

The claim ultimately made by the producers, however, was that Searchlight should have applied the higher rate, 31.66%, across-the-board, to all DVD revenue. This would have increased the amount to be shared by the producers from \$17.9 million to \$44.1 million, a jump of \$26.2 million. After deduction of a 25% distribution fee (which was uncontested), the asserted increase would have been \$19.6 million.

Since the producers shared profits with Searchlight on a 50/50 basis, their share of the \$19.6 million would have been \$9.8 million. So, this claim, rounded up, was worth \$10 million.

If all of these figures are a bit confusing, suffice it to say that, when you start with \$139 million in distributor's gross, even a moderate shift in a royalty rate can put a lot of money in play.

Audit Process and the Claim

At key points in the distribution and audit process, the producers, their sales agent and their auditor didn't challenge the dual royalty rate structure of 31.66% for rental priced DVDs and 10% for sell-through. They questioned at what unit prices these rates should apply, but not the two rates as such. Indeed, the auditor's report that was marked "final" expressly acknowledged the two rates.

Fifteen months after his final report, though, and on the eve of trial, the auditor issued a supplemental report in which he rejected the 10% sell-through rate category, on the basis that it wasn't properly part of the governing contract. This supplemental report claimed, apparently for the first time, that the full 31.66% rate should apply to sales of DVDs at *all* conventional price points.

The Referee's Report

In her "Proposed Statement of Decision"¹ which, on this issue, favors Searchlight, the judicial referee homed in on the auditor's change of position. She noted that for almost seven years, the film's producers and their sales agent had conducted themselves as if the Searchlight documentation, which included the dual rates, was in effect. Their conduct, she concluded, demonstrated that they "intended to be governed by" the dual rates.

Although the referee didn't expressly use this terminology, her analysis is analogous to the principle of "practical construction" – the notion that how a contracting party performs can be an important indicator of a contract's meaning, especially if that party later asserts a meaning inconsistent with their actions. Or, put differently, actions speak louder than words.

Timing

Although the precise text of the contract was fixed on signature, once accounting statements started to flow, and prior to audit and litigation, the producers and their team had the opportunity to argue that the contract called for the high price royalty rate only, but they didn't. Later, when the audit process began, and prior to their auditor's "final" report, they had another opportunity to take the "one rate fits all" position; this time they were slow off the mark. When they eventually took this position, it was well after issuance of the final audit report, and on the eve of trial.

The Answer

The answer to the multiple choice question is C: 12.88%. The referee, in her report, rejected the producers' challenges to this effective rate².

¹ *Napoleon Pictures v. Fox Searchlight Pictures*, No. SC 113978 (Super. Ct. Cal. Nov. 29, 2012); affirmed 2015 WL 1594299 (Cal. Ct. App. Apr 14, 2015)

² The *Napoleon Dynamite* dispute occurred in the context of the transition, in the late 1990's and early 2000's, from a DVD rental to sell-through business model. The home video sector, of course, is now undergoing another major transition – from physical units (DVDs and Blu-rays) to a digital model.

What This Case Means for You

In your business, if you commence an audit, develop your “final” position before you approve a final audit report. And if you see litigation on the horizon, assert your final position early, and often.