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<u>Client Alert</u>: *Crash* Profits Restated; Court Responds with "Big Interest"

By Ezra Doner*

Can a film company issue a participation statement, then later revise and reissue it, making major changes in its favor? If the changes are decidedly wrong, can there be consequences?

Profit definitions typically give film companies an express right to correct mistakes, even retroactively. After all, mistakes get made.

But on January 31, a California appellate court, in a long running litigation over profits of the film *Crash*, rejected a film company's revised profit participation statements to key talent[1]. Calling the changes "bogus", the Court confirmed a $2.5 million interest add-on to a judgment for more than $9 million of unpaid profits.

<u>How it Started</u>

Crash, Oscar winner for Best Picture of 2005, was a box office success, especially in relation to its production cost. When the film company issued its first profit statements, the filmmakers' auditor claimed that profit participations had been underpaid. In response, the film company, citing its own newly discovered "mistakes", claimed that, to the contrary, it had overpaid the participations. Litigation ensued.

<u>The Underlying Contracts</u>

The filmmaker group, which included Paul Haggis, Bobby Moresco and Brendan Fraser, wrote, produced, directed and starred in *Crash*, pursuant to agreements with companies controlled by film financier Bob Yari (herein, collectively, "Yari")[2]. Starting at a defined breakeven, the filmmaker group and Yari had agreed to share defined profits on a 50/50 basis.

"Gross Receipts" were defined in the agreements as all monies actually received by or on behalf of, or credited to, Yari, and "third party participations" were a permitted deduction in determining profits. The meaning of these defined terms was a principal focus of the litigation.

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[1] *Paul Haggis, Inc. v. Persik Prods. No.* B240556 (Cal. App. Jan. 31, 2014). Because the opinion was not certified by the court for publication, it may not be cited or relied upon in any other case. Nevertheless, readers may find the Court's analysis instructive.

[2] The Court found that the defendant entities were all under the ultimate control of Bob Yari and his holding company, Davand Holdings LLC. In a separate ruling, however, the Court held that a late amendment of the judgment adding Yari, as an individual, had been improper.

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What Is A "Third Party Participation"?

When Yari restated profits to correct its own "mistakes", one of the changes was to re-characterize return on investment to a co-financier[3] as a "third party participation". As a participation, payments to the co-financier would be ahead of the filmmakers, reducing the profit pool in which the filmmakers shared. On the other hand, if the payment to the co-financier stayed as a return on investment, it would be borne by Yari, and not reduce the filmmakers' share.

The trial court, in rejecting Yari's revision, noted that neither sides' contract negotiators, nor an expert witness, had understood "third party participations" to mean or include payments like those to the co-financier.

Whose Revenues are Gross Receipts?

Another "correction" put forward by Yari was the exclusion, from Gross Receipts, of certain picture revenues which, per the financing agreements, were initially routed to the co-financier. In prior profit statements, however, Yari had treated these revenues as Gross Receipts. Excluding these revenues would have also reduced the pool of profits in which the filmmakers shared.

The Court, in rejecting this revision of the participation statements, pointed to provisions in the Yari / co-financier agreement that the financiers would pool receipts and pay talent participations from the entire pool.

Practical Construction

In scrutinizing the alleged corrections, the Court looked to Yari's "predispute, post-contracting conduct" – the initial profit statements – as "powerful evidence" of the true meaning of the agreements. This legal principle is sometimes known as "practical construction" – the notion that how a contracting party performs a contract can be an important indicator of the parties' real intentions, before a revisionist impulse clicks in.

The Price Of A Bad Faith Claim

In the *Crash* case, the dispute had been pending for so long, and the underpayment of profits had been so substantial, that prejudgment interest, on the underpayment itself, was a hefty $2.5 million. Were the filmmakers entitled to this much interest?

Under the general rule in California, a prevailing plaintiff in a contract case may not be entitled to prejudgment interest if the amount owed is not readily determinable because of a genuine dispute as to the method of calculation. In this case, however, the Court awarded interest under a bad faith exception. In particular, the Court cited findings of the trial court that Yari's contractual interpretations were "bogus", and that Yari had engaged in "creative accounting",

[3] The co-financier was German media fund Apollo.

"an intentional scheme to withhold money" and a "diversion of funds" – pointed language that one does not often see in legal decisions.

What This Case Means For You

Judges may or may not know the difference between third party participations and return on investment, or excluded revenues and accountable gross. But they do know when litigants change positions. Reading between the lines, this Court was seemingly more circumspect about the Yari companies' positions than it might have been if those positions hadn't been changed.

Changed positions were similarly a factor in the *Napoleon Dynamite* case, which I wrote about at http://donerlaw.com/client-alert-napoleon-dynamite-litigation-choose-the-correct-dvd-royalty-rate. In that case, it was the participant's auditor and counsel who changed positions, but the general point I made there applies equally here. If you are a film company with a breakout picture, develop a good faith, best case position before you issue a first profit statement.