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<u>Client Alert</u>: *The Walking Dead:* Should AMC be paying less than $2 Million Per Episode for this Mega Series, or more than $20 Million?

Writer/director Frank Darabont is the creator of mega series *The Walking Dead* (the "Series"); talent agency Creative Artists Agency is the Series' packager; and AMC Studio is the producer and distributor of the Series, and licenses it for broadcast to the AMC Network[i].

Plaintiffs Darabont and CAA, who share in the profits of AMC Studio, claim that the AMC Studio and the AMC Network together improperly set a below market, "sweetheart" license fee for the Series of less than $2 Million per episode, thereby shortchanging the plaintiffs.

By contrast, plaintiffs' expert, whose report was recently made public, puts the fair market value of the license fee not at $2 Million per episode, but at more than $20 Million – at first blush, an astounding number.

<u>Multiple Choice Test</u>

Which of these data points did plaintiffs' expert incorporate into his valuation?

A. After renegotiation, the average license fee for the AMC series *Mad Men* and *Breaking Bad*, produced by unaffiliated studios, was $3.32 Million per episode.

B. NBC and CBS pay the NFL $45 Million per game for *Thursday Night Football.*

C. One-third of AMC's annual revenue of $1.3 Billion is attributable to *The Walking Dead.*

D. All the above.

Here's the detailed answer (shorter answer follows at the end).

Arm's Length Negotiations

When a television studio licenses a series to an unaffiliated network, the per episode license fee is typically set by means of arm's length negotiations. The studio wants as much as it can get, the network wants to pay as little as possible, and a spirited negotiation ensues. But where, as here, the studio and the network are affiliated (that is, under common ownership), by definition, the negotiation is not at arm's length.

Operative Language

The profits definition in the agreement which Darabont signed does not designate a specific per episode license fee for *The Walking Dead,* or even a specific formula. Instead, the signed agreement provides that the per episode license fee will be on "monetary terms comparable to the terms on which [AMC] enters into similar transactions with unrelated third party distributors for comparable programs."

The Rate Set By AMC

Per allegations in the case, after Darabont signed his agreement, AMC unilaterally set the per episode license fee for the Series at 65% of production costs, with a cap of $1,450,000 per episode (subject to cumulative 5% season-to-season bumps). In contrast to a "negotiated license fee" (that is, a fee set via arm's length negotiation), a fee between related companies is sometimes called an "imputed license fee". When revenue participants claim that a deal between related entities shortchanges them, they often call such an arrangement a "sweetheart deal".

The Expert's Approach

The plaintiffs engaged economist James Dertouzos to examine whether the imputed license fee set by AMC reflects the fair market value of the Series. The expert framed his analysis with these questions:

"What has AMC paid for 'comparable' programs in transactions with unaffiliated third parties?" The expert calls this path of investigation "Comparable Sales to AMC Network".

"What have other networks paid to acquire successful programs in the past?" The expert calls this path "Comparable Sales to Other Networks".

"What is the value of *The Walking Dead* to AMC"? The expert calls this the "Value Method" and analogizes it to the "income method" for valuing businesses.

Comparable Sales to AMC Network

Plaintiffs' expert Dertouzos put forward these (and other) data points regarding comparable sales to AMC Network.

** After renegotiation with independent studios following season four, the combined average license fee for AMC Network's *Mad Men* and *Breaking Bad* was $3.32 Million per episode. (Lionsgate is the studio for *Mad Men*, while Sony Pictures Television is the studio for *Breaking Bad*.)

** Before renegotiation, the combined average live plus same day rating for these series was 0.59 in the 18-49 year-old demographic. ("Rating" is the percentage of TV households that watches a show; a rating of 1.0 means that 1% of U.S. households tuned in.)

** Accordingly, AMC was paying $5.62 Million per rating point for these series ($3,320,000 divided by 0.59 = $5,620,000)

** The average comparable rating of *The Walking Dead* in the first through fourth seasons was 5.11 points.

** Applying the episode license fee price per ratings point paid for *Mad Men* and *Breaking Bad*, the per episode price of *The Walking Dead,* after renegotiation, would have been $28.7 Million (5.11 points multiplied by $5.62 Million per point = $28.7 Million).

Comparable Sales to Other Networks

Plaintiffs' expert Dertouzos put forward these (and other) data points re: comparable sales to networks other than AMC:

Based on other hour dramas in the marketplace (including megahit *ER*), the plaintiffs' expert developed an imputed license value of more than $23 Million per episode for *The Walking Dead*. Plaintiff's expert then opined that the $45 Million per game license fee for *Thursday Night Football* is consistent with that value for *The Walking Dead*. He got to this result as follows:

$45 Million per game for *Thursday Night Football* translates to $15 Million per game hour; the 2015 upfront spot rate for *Thursday Night Football* was $465,000; and football had no meaningful rerun value and only limited benefits in terms of affiliate revenues from cable service providers. By contrast, AMC's 2015 spot rate for *The Walking Dead* was $500,000, it has numerous reruns of each episode. And, per plaintiffs' expert, for every $5 in advertising sales and other program revenues, AMC can expect as much as $4 in affiliate revenues – that is, fees paid by cable and satellite service providers such as Comcast, Cox and Direct TV to carry networks like AMC. So, in the view of plaintiffs' expert, adding the value of Series' reruns and allocated affiliate revenues to a $15 Million base price supports a $23 Million per episode value for the Series.

Value Method

Plaintiffs' expert Dertouzos offered yet a third way to generate an imputed license fee for *The Walking Dead*, which he calls the value method. In 2016, AMC's gross revenues were projected to reach $1.3 Billion. Per Dertouzos' calculations, at that time, 26% of AMC's total viewership was directly attributable to *The Walking Dead*, and a further 7% was indirectly attributable via the "tentpole effect" of the Series. On this basis, the combined 33% share of Network viewing generated by *The Walking Dead* meant that one-third of AMC's gross revenues, or $433 Million, was attributable to the Series. Allocating this $433 Million over 16 episodes amounts to $27 Million per episode which, in the expert's view, "represents a conservative upper bound to the fee that AMC Network would be willing [to] pay for a program with properties of *The Walking Dead.*"

This $27 Million is roughly in line with the imputed license fees which Dertouzos developed using his other methods.

Answer to the Multiple Choice Test

So the short answer to the Multiple Choice Test question about data points is: All of the above. In other words, all of the given data points formed part of the expert's opinion.

How did the Parties Get Here?

A key element of this case is that Darabont and CAA claim that they never agreed to AMC's imputed license fee formula based on 65% of production costs. They assert that AMC did not even propose this formula until after the Series' first season. If that formula had appeared in the text of the agreement that Darabont signed, this litigation might never have happened.

What This Means for You

In the filmed entertainment sector, it's not unusual for at least some price terms to be left to later determination. Depending on the transaction, that may make sense. But if you don't timely nail down a foreground price term like a per episode license fee, you run the risk that a court or jury may set that term for you.

Caveat #1

This Client Alert is obviously an oversimplification of Dertouzos' expert report. My limited objective here is to introduce certain of the expert's calculations and concepts (for what they're worth).

Caveat #2

If AMC Network were to pay a $20 plus Million per episode license fee for *The Walking Dead*, economically, much less than the full $20 plus Million would function as a real expense. AMC would essentially be making bookkeeping entries in which its Network was debited by, and its Studio was credited with, equal amounts. The real economic expense would be limited to the amount of the incremental profit shares of Darabont, CAA and perhaps others who participate in profits at the AMC Studio level.