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Client Alert: Harlequin e-Books Royalty Case: A Dollar or a Dime?

By Ezra Doner*

In entertainment and media, sometimes business practices evolve more quickly than standard contracts.

As recently as 2004, Harlequin Enterprises, the leading publisher of romance novels, did not specify a royalty rate for e-books in its author agreements. Rather, e-book sales were lumped into an "other rights" category originally intended for book clubs and other activities handed off to third parties, with revenue under this category shared between publisher and author on a 50/50 basis.

Multiple Choice Question:

Even though Harlequin has now taken much of its e-book activity in-house, this 50/50 revenue arrangement, unless amended, continues to apply to e-publishing of older titles. But under the original agreements made in 2004 and earlier, what percentage of e-book revenue is Harlequin *actually* reporting to and sharing with authors? Specifically, under these older agreements, does Harlequin report and share:

A. 100% of gross e-book sales, or
B. 70%, or
C. 50% or
D. between 6% and 8%?

For the answer, keep reading.

The Lawsuit

In *Keiler v. Harlequin Enterprises*, a class action lawsuit, authors are challenging Harlequin's accounting for e-book revenue under publishing agreements from 2004 and earlier (herein, "*Keiler* agreements"). After an initial dismissal on technical pleading grounds, an appeals court, in a revealing decision, recently revived the suit. See *Keiler v. Harlequin Enterprises*, 751 F. 3rd 64 (2d Cir. 2014).

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Business Context for the Dispute

From 2008 to 2012, U.S. e-book sales grew from $64 million to over $3 billion annually, a startling increase of over *4,700 percent*. And since distribution costs for e-books are so much less than for print (no paper, ink, warehousing or freight), e-books are especially profitable for publishers. Harlequin, like other publishers, has benefited from this explosion in e-book sales.

The rise of e-books, however, has exposed an inconsistency in Harlequin's royalty accounting practices. When it comes to print books, Harlequin has typically applied a modest 6% royalty against author advances and, once the advance is earned out, paid a royalty in that amount to the author. But for e-publishing of back catalog, older agreements continue to provide that 50% of e-book revenue will be credited against author advances and, once an advance is earned out, will be paid outright.

Now, authors in the *Keiler* case claim that Harlequin, through abusive arrangements with its subsidiaries, is trying to minimize the amount of shared e-book revenue.

Related Company Provisions

Under the *Keiler* agreements, Harlequin has the right to enter into agreements with companies that it owns – so-called "related companies". But if e-book and "other rights" are licensed to a related company, then per specific contract language, the amount paid by one Harlequin company to another must be "equivalent to the amount reasonably obtainable" from an unrelated company.

For the *Keiler* authors, how much e-book revenue has Harlequin actually moved from one Harlequin company to another? And if Harlequin had licensed e-book rights to an unrelated company, could it have obtained more e-book revenue than the amount it actually reported to the authors?

Harlequin Business Structure

Some years ago, Harlequin, seeking tax efficiencies, started designating Swiss subsidiaries as the nominal "publisher" in its author contracts. While, for practical purposes, Parent Harlequin continued to function as publisher in both print and (later) e-book media, Parent paid the nominal publisher only 6% to 8% of e-book revenue. The nominal publisher then reported this 6%-8% to authors as a "new 100%" – that is, as the *entire pool* of revenue which author and publisher were to share on a 50/50 basis.

So, the answer to the Multiple Choice Question at the top of this post is "D". Under these older agreements, Harlequin does not report 100% of its e-book sales, or 70%, or even 50% to authors under the *Keiler* agreements. Instead, Harlequin reports between 6% and 8% of e-book sales, and of this amount only 3% to 4% actually accrues to the author.

Ten Times Multiple

In an *amicus* (friend-of-court) brief in the case, the Romance Writers of America and the Authors Guild characterize the 6%-8% intercompany e-book royalty as an "unprecedented

artifice" to deprive authors of the real benefit of the 50/50 e-book revenue sharing arrangement. They believe that, because of its dominance in the romance novel genre, Harlequin, in reality, would be able to obtain license fees of 50% to 70% of retail e-book sales, which at the high end is as much as ten times the 6%-8% that Parent Harlequin remits to Swiss Harlequin, the affiliated nominal publisher.

In everyday language, if Jack at Parent Harlequin can make a dollar from e-books, may Jill at Swiss Harlequin tell authors that they only made a dime?

Status of the Case and Key Issue

To be clear, so far, the Court in *Keiler* has not ruled that Harlequin has done anything wrong, much less that the company is liable for damages. In its recent decision, the Court merely held that the authors' pleadings are technically sufficient for the case to go forward.

Postscript

On May 2, the day after the *Keiler* case was revived, Harlequin announced a $420,000,000, all cash sale of the company to Rupert Murdoch's News Corp, which owns publisher Harper Collins. Presumably, the announcement had been held pending the Court's decision, and deal terms of the sale take into account possible outcomes in the litigation.

Post Postscript

April 2016 – Documents in the docket for this case seem to indicate that this case is on a path to settlement.