

## THE BUSINESS RELATIONSHIP BETWEEN PRODUCERS/STUDIOS AND TELEVISION NETWORKS IN THE UNITED STATES

Presentation notes by Richard Hofstetter, June 28, 2010

I was asked to address the MediaForum panel to examine the business relationship in the United States between producers and broadcasters; to see whether the U.S. model might be useful in the structure of agreements between similar parties in Europe. As a lawyer I represent producers, writers, performers; and I represent distributors and networks. Of course never in the same deal. My law firm also represents many advertising agencies and brands – companies that want more of a return for their investment than a 30 second message delivered on screen during television programming breaks. The advertising agencies are creative-based, but they now want ownership rights in the intellectual property they create. It is important to recognize in the United States that it is the advertisers whose money is at the heart of funding the creation and broadcast of American television.

[For this discussion I will interchange the terms “producer” and “studio”; and “network” and “broadcaster”. And when I discuss “off-network”, that refers to platforms on which to exploit programs following their network run (e.g., on broadcast channels in the US on market by market domestic syndication, or international (outside US), DVD, etc).]

We begin with a perspective on the power of television in American culture. Even in an environment where technology has empowered people to be free of schedules set by broadcasters, to allow them to choose when they want to watch as well as what they want to watch: In an average US home, the TV is on more than 7 hours each day; and the average American watches more than 5 hours of TV each day. A one year old child watches at least 6 hours of TV each week. And while the average American child spends 900 hours each year in school, that same youth spends, on the average, 1,023 hours per year watching TV. 49% of Americans do say they watch “too much TV”; but then again, 40% of Americans always or often watch TV while eating dinner; and 25% of Americans fall asleep with the TV on at least 3 nights each week.

U.S. television production costs continue to increase (not just due to lawyers like me and agents demanding more for talent and producer fees). U.S. advertisers, networks, studios and producers all are looking for their own new models to find the revenue to cover their costs and yield a profit margin that “makes it a more worthwhile business”. And the audience demands productions of quality that seems to cost more.

How much do U.S. television programs cost? A typical broadcast network pilot now costs between \$5 – 8 Million/hour, with series episodes at \$2.5 - \$3 Million. Comedy is a bit less expensive to produce, although those pilots now are approximately \$3 Million/half hour. Even advertiser-supported basic cable network production costs have escalated, with scripted programs at approximately \$1 – \$2.5 Million/hour; the less expensive basic cable unscripted series at least \$200,000 - \$600,000/hour.

Networks have witnessed the dilution of their audiences as there are more networks from which the audience can choose programs. DVD sales have plummeted as networks and others offer VOD, at will downloads (streaming) and other platforms. And networks have met more resistance from advertisers who are asked to pay higher costs for commercials. Remember: the business of television in the US is driven by advertising. Even with tune out (Tivo, DVRs, etc.), commercial broadcasters must make the money to pay for programs from advertising revenue. And advertisers want better means to deliver their messages.

The historical and legal relationship in the U.S. between networks and studios/producers. U.S. television has grown in 3 evolutionary stages.

(1) In what is considered the birth of commercial television in the U.S. in the early 1950s, the networks owned all rights in the programs they broadcast. Programs were broadcast live, and no one imagined any life in a program after it was first telecast (although some programs were recorded on kinescope for archive purposes). There was no notion of ancillary rights (international rights, off-network syndication or home video).

(2) In 1970 in response to the U.S. federal government's anti-trust claims against the three broadcast networks (ABC, CBS, NBC), those networks signed a consent agreement for the most part prohibiting their ownership and financial interest of programs or any rights other than the license to broadcast programs on their network for a limited amount of times over a limited period. This was known as the "Financial Interest rule".

Under the Financial Interest rule, the Network model agreement with producers was simple: The Network paid a license fee for the right to broadcast 2 runs of a program over a period of 2 years, just on that Network (domestic); otherwise the program was owned by the Studio. The license fee was an amount less than the program's budget, which required the studio to produce at a financial deficit. The network had annual options to require the studio to produce and deliver usually 13 -22 new episodes per year – thus putting studio into a deeper deficit hole. EXCEPT the studio could make up this deficit (and even make a profit) from off-network exploitation (e.g., international broadcasts, home video, as well as domestic syndication). Increasingly, the studio goal was focused on money from off-network exploitation. Following the exclusive network broadcast period, independent distribution companies (sales agents) licensed the programs (on behalf of studio/producers) on a market by market basis in the US and internationally; as well as selling advertising time to sponsors in the off-network broadcasts (known as barter sales). In many cases programs were given to local stations for free in return for these barter advertising spots. This proved lucrative enough so that even with lower network license fees, the producers/studios made significant profits. The networks watched as the license fees demanded by the studios grew. Then the studios acquired greater ownership in the distribution companies. Until . . .

(3) In the 1990s, in response to Network claims that the Financial Interest rule was unfair because it didn't apply to HBO (pay cable) or Fox (and other smaller networks that didn't broadcast as many hours per week as the 3 largest networks), the government ended the Financial Interest rule prohibiting network ownership; and once again the networks could own television shows, and the studios that produce them, and the companies that distribute them off-

network. Combine this with a consolidation of the ownership by networks of their own secondary cable networks. Networks wanted their share in the “pot of off-network gold”. This is the current state permitted by federal rules; basically little regulation of ownership across all platforms.

### WHAT ARE THE MODELS NOW?

In a buy-out (or commission) environment, the Producer has no ownership rights; he negotiates a production fee (usually 10% of budget) plus overhead (actual or 12% budget). The producer has no financial responsibility as long as he delivers on time and on budget. The producer depends on a “volume business”. But even in this model shrewd (or well-represented) producers will negotiate for some or all of the following:

- Get the network to order a minimum number of episodes per year for which it wants to have the series produced. Since the producer has no deficit responsibility, get the network to commit to pay a fee for a minimum number of episodes in any year in which the producer is engaged to produce.

- Have the network commit to “lock” the producer for the life of the series; as opposed to the network option to replace the producer at any year. One variation to negotiate is a vesting of the right to produce: try minimum of two years to attach the producer if the network orders the series; plus for each year in the aggregate that the network then elects an option for producer to produce, the producer is attached for an equal number of years as a consultant at 50% of the producer fee. In addition, the producer might be locked as producer (or consultant) to any spin-off or derivative work based on the original program. Or at least the producer might have a financial participation in such new work.

- To the extent possible the producer should control the production budget. Management of the budget will allow the producer, without network approval, to apply cost savings in certain areas to overages in other areas, thus avoiding budget overages which might otherwise be the producer’s responsibility. In addition, the producer might be entitled to keep any budget underages (or maybe 50% of underages) as an incentive to produce efficiently. Producers should negotiate to allow budget line-item expense items to be used for producer owned entities (e.g., editing and post-production equipment). This is not a ruse. If the rate charged is competitive, it won’t make difference to network that it is another profit center for producer (it has to be paid to someone).

- The producer should negotiate an incentive benefit based on the performance of the program. Ratings bonuses or series production bonuses: pre-negotiated cash amounts tied to benchmarks of a series being ordered to production each year or achieving viewer ratings level.

Some networks (even in a buy-out arrangement) will give a producer a financial participation in revenue from ancillary rights in the program (e.g., off-network distribution, international distribution, merchandising, DVDs). This is far short of control for the producer; and might be valuable only if the “profits” definition is carefully negotiated. Example, the network will want to deduct from revenue all production costs of program. We try to attribute a

portion of revenue as an imputed license fee from the network so that the network bears some cost for its broadcast rights before taking profits.

- While (as discussed below) producers still try to negotiate a share in the network's advertiser revenues, for the most part the networks still treat this as untouchable for many reasons.

Is a buy-out always the answer for the networks? With production costs on the increase and less predictability of revenue from off-network rights, the buy-out scenario is not always the best arrangement for a network. In the U.S. where advertiser revenue still is the primary source of funding for programming, and where advertisers are dissatisfied with the money the networks ask from them for commercials that technology allows viewers to zap, the networks are more concerned than ever about deficits - Deficits that they are not sharing with producers as they did under the Financial Interest rule. Even in this environment there are producers of such stature (based on their track records) who still can demand a financial interest or control of some off-network rights if the network wants a show they create. Many times a negotiation to obtain a share of off-network rights for the producer will depend on who the producer is - and whether the producer is the creator of the show. Once again networks, especially cable networks, might be willing to give up rights in exchange for producers' sharing of deficit responsibility.

One hurdle the networks must overcome is internal resistance to part with rights. In a consolidation environment where the network owns its distribution division and secondary platforms (e.g., cable), as well as international channels, it is not easy for the network conglomerate to part with any rights. Still in some cases, the network might give up certain off-network rights in return for (i) less of a financial commitment from the network, i.e., a lower license fee and (ii) sharing the deficit responsibility. The most likely off-network rights that the network will give up are international rights. Still, there are many issues to negotiate in any such agreement. The producer will need to commit to cover the deficit or to find a partner to cover the deficit (usually a distribution company to sell rights or a co-producer to obtain rights in a particular territory).

In any co-production negotiation with a network, consider the following:

In return for the producer obtaining international rights from a network, the customary deficit responsibility the producer must bear is 20% to 40% of the budget. So now the producer has to have sufficient comfort that it can produce the show on budget and that this particular show will generate the deficit amount on a net revenue basis from those areas in which rights are retained by the producer and its partners. The international distribution market from US shows has declined, especially from shows originally produced for US cable networks, and especially for unscripted (as opposed to dramatic or comedy shows). In its co-production negotiation with a network, in addition to retaining rights in the so-called "ready makes" (i.e., the actual shows produced for the network), the producer should try to get format rights in the series (which generates a license fee in every territory as well as the possibility of a production fee in each local territory to guide the local producer through the development and launch of its local series). Additionally, the producer should try to negotiate the rights to produce and distribute

derivative programs and spin-offs. And the producer should make sure that the retained rights include all ancillary rights in the territory including merchandising), not just television.

US networks that have affiliated broadcast entities in international territories will try to get first negotiation and matching rights for their international affiliates even where the producer has the distribution rights in the territory. Networks might back down from this position or at least agree just to a first negotiation at a customary price in the territory.

It's not unusual for a US network to ask for a net participation in the producer's international revenue. This is acceptable so long as it is net of customary distribution fees and expenses, and allows the producer and its partners to recoup any deficit contribution prior to the network's participation. In return, the producer should try to get a net participation in the off-network revenue in the US (even where the producer does not control those rights). The network must view the producer for this purpose as a co-financier of the program, rather than just the producer or international distributor. This producer participation in domestic off-network rights should include all ancillary rights (e.g., DVDs or downloads, and merchandise rights).

As a co-production partner, it is important for the producer to have some level of creative and financial approvals. Since the producer now is responsible for a significant portion of the budget, and the producer wants to make sure the program is viable for international sales, the producer might negotiate for some approvals over the budget and even over the format or casting. If the producer has a co-production partner in a territory that has content based minimums, it is even more important to pre-negotiate this control. The co-production producer should try to control the program's production location to take advantage of regional tax credits. In the U.S, these credits can result in 20% to 30% savings in production costs. In the network agreement, the producer must negotiate who will get the benefit of these tax credits.

In a co-production agreement, the producer should limit the number of production order options that the network has to require more years of shows to be produced – which will increase the producer's requirement to produce and bear deficit responsibility. A co-financier/production partner might not want to make a long-term commitment in advance to the producer to deficit additional years or production orders of the series. In the agreement with the co-financier/production partner, the producer should try to obtain this long term commitment based on performance benchmarks relating to how the series performs in the U.S.

Where the producer has created the series, then regardless of the co-production or international rights arrangements, in any agreement between the producer and the network, the producer should try for a reversion of rights to the producer if the network does not order the series (or possibly where the network cancels the series). This might entail reimbursement to the network of its costs (both development and initial production) and maybe a continuing financial participation for the network if the producer continues with the series after the network has cancelled it. Even following a series' cancellation, a U.S. network will be reluctant to allow the series to be broadcast on another U.S. network. The networks view series they broadcast as their "brands" and they don't want them on competitor networks.

With greater frequency, producers are developing programs that bypass network broadcast, e.g., webisodes. These are less expensive, less regulated by the government, and can be created for and supported specifically by an advertiser. These alternative initial delivery means allow an audience to build and to be involved on an interactive basis – creating enough of a following to attract both a network and advertisers to evolve to a network broadcast run.

To return to the subject of the advertisers, as stated above, advertising revenue is the predominant source in the US to fund television programs. Traditionally the networks would sell advertisers 30 second commercial spots within a program break (usually a total of 12 minutes of commercial time within a 60 minute program). Advertising rates are determined by the number of people and demographic of who is watching. Networks rarely will share this revenue with anyone.

The advertisers became dissatisfied with the 30 second commercial model – especially given technology that permitted viewers to skip their commercials. So they pushed to have their messages integrated within the program content of the shows; because Jennifer Aniston drinking a can of Coke in Friends would have more significant impressions on viewers than a commercial in the program break when the audience goes for a snack or to the bathroom. So product placement was born – innovative and able to attract even more revenue from the advertisers than a 30 second commercial. But the product placement is within the program content – created by the producer and the studio; So should the advertiser money go to the producer, the studio, or the network? So began the fight for product integration revenue.

This was compounded by advertisers who began developing ideas for their own programs to feature their products. If it was their money that paid for the production, then why shouldn't they participate in the revenues and profits from the shows? Or even control the content.

The fight continues among all three: networks, studio/producers, and advertisers.

Here's what we have learned regarding brand integration:

The audience begins to resent products that are obviously “placed” in a program. A good placement must be seamless within the content of the program. Writers and actors will refuse to corrupt their “art” with inappropriate or out-of-character placements.

The U.S. Federal Communications Commission (“FCC”) requires disclosure whenever money is paid to include a product in the content of a program; which can lead to the program being treated as a commercial and subject to non-program rules.

Actors who are paid substantial amounts of money for endorsements do not want to be associated with a product in a program for free. Moreover, the U.S. Federal Trade Commission requires substantiation for any product claim made by an endorser; so the actor could be held responsible for the accuracy of any claims about a product.

What seems to be evolving in the area is a brand integration that goes outside of a placement in a program (or maybe in addition to it). For example, a particular product wants to

be identified with a television series. More of a cross-promotion than just in the program. Perhaps the product is featured on other media platforms: on-line, or internet contests, print, sponsoring added scenes, fan chats, and other areas in deals directly with the producer and outside of the broadcast. The networks are not happy. The network advertising sales departments are supposed to sell and control the revenue advertisers pay for including their messages in connection with a network series. They claim the revenue should go to them to reduce production costs. Brand integration revenue is much tougher to allocate than revenue from an in program product placement. The advertising sales departments are working with high-end producers and studios to resolve this. NBC has set up a system to track and analyze the value of brand integration so that the parties might agree to a revenue percentage split. Two things are certain: Advertisers are willing to spend much more money in this area, both in “placement buys” and in their own creative efforts to find new platforms to cross promote their brands with a program; and broadcasters and producers/studios will have to find a way to share this revenue to work together.

In conclusion, the U.S. model continues to evolve; but producers (both U.S and throughout the world) should be guided by the following:

- Don't depend on volume business.
- Try to negotiate a lock to produce a series if it is ordered; and get some control of the budget – without a disproportionate share of deficit responsibility.
- Try to lay off deficits by obtaining guarantees from co-distribution/financier partners and by licensing international off-network pre-buys from local production partners;
- Take advantage of tax credits;
- Find a way to let the advertisers in; both creatively and financially. They are willing to spend money to deliver their brand message in creative ways.
- Consider new development and alternative exploitation platforms. They are less expensive and allow more control for the producer.
- Finally, get a good lawyer.