Deals

David Schizer

**Discussion Questions 8: Motion Pictures**

1. *Paramount* and the End of the “Studio Era”
2. What are the 3 phases in producing a motion picture?
3. Between 1915 and 1948, movies were made in what is called the “studio era.” What was its defining feature?
4. What is vertical integration? How is it different from horizontal integration?
5. In *Paramount*, the Supreme Court concluded that it was anticompetitive for the same company that made movies also to own movie theaters.
   1. Why might it be in the interest of movie producers to limit the number of movies that are made?
   2. Assume that only three studios make movies, so there is significant horizontal integration in the production phase. Does this situation seem like it has the potential to be anticompetitive?
   3. Assume that the profit-maximizing number of new movies released each year is 150. Assume you are CEO of one of the studios and assume (counterfactually) that the law does not prevent you from striking a deal with the other two CEOs, so that each of you commit to make only 50 movies each year, keeping the total at 150. If the other two CEOs honor the agreement, is it better for you also to honor it? If you have the ability to “cheat” and secretly make and sell another five movies, would it be in your interest to do so?
   4. Assume that 10 studios make movies and they also all own theaters. Each makes 1/10th of the movies and owns 1/20th of the theaters. Does this seem more or less likely to produce anticompetitive outcomes as “iii”?
   5. Assume that 10 studios make movies, but only 3 of the 10 own movie theaters. Each owns ⅓ of the theaters in the U.S. Does this seem more or less likely to produce anticompetitive outcomes as “iii” and “iv”?
   6. True or false: By owning movie theaters, studios have the ability to prevent new studios (who don’t own theaters) from displaying their movies. This control over exhibition can give them added market power in production and distribution.
6. Alternative Explanation for Vertical Integration: Response to Uncertainty
7. Sometimes a market practice exists not because (or, at least, not solely because) it gives the relevant firms market power; sometimes the practice also is efficient. To explore whether this is the case with vertical integration, we need to dig into the economics of the industry. According to Arthur De Vany, what factors drive the demand for movies? What role does the dissemination of information play?
8. According to De Vany, what is the key moment that determines the success of a movie? Is it the opening? Or another moment?
9. Does Devany think that when a movie is being made, its chances of success are a matter of uncertainty? Or asymmetric information? What is the difference?
10. Is it controversial to say that predictions about a movie’s popularity *before* it is released can never be as accurate as evidence gathered *after it already has been released*?
11. According to Hanssen, why is it important to make commitments about exhibiting a movie before the movie has been released?
12. According to Hanssen, what is the downside of making these commitments before the movie has been released?
13. To balance the tradeoff Hanssen identifies, one option is to include a mechanism in the contract to shorten or lengthen the running time of a move. Why is this hard to do?
14. How could vertical integration solve this problem?
15. Once vertical integration became illegal, what else could the industry do to base run rates for a film on ex post evidence (of whether the audience actually liked it), instead of ex ante predictions (of whether they will like it once they see it)? (Hint: Does a movie have to be released everywhere at the same time?)
16. Minimum Price
17. In the studio era, when a distributor licensed a film to an exhibitor, the license typically required the exhibitor to charge a minimum ticket price in showing the movie to the public. In *Paramount*, the Court deemed this minimum ticket price an illegal price fixing conspiracy: “‘a price structure is erected which regulates the licensees' ability to compete against one another in admission price,’" the Court said, quoting the district court. “That consequence seems to us to be incontestable.” Please offer a defense of the Court’s conclusion. Why might this be the case, at least in some cases?
18. Assume that Danny grants an exclusive license to Ellen in exchange for 50% of ticket revenue after Ellen has recovered her costs.
    1. Why does it make sense for Danny and Ellen to share revenue?
    2. Ellen decides to offer tickets for $8 (instead of the usual $10) to any customer who spends at least $5 on snacks. How might this promotion disserve Danny’s interests? What condition could he specify to protect those interests?
19. Blanket Deals, Franchises, Blind Selling, and Block Booking
    1. Ellen owns fifteen theaters across the country. Danny offers Ellen discretion to choose which of her theaters should display his films (a “blanket deal”). Danny gives Ellen a license for all his movies for more than one season (a “franchise”). Danny offers Ellen a license not just for a single movie, but for all forty movies that Danny plans to distribute in the coming year. The Court disallowed all of these practices, viewing them as “devices for stifling competition and diverting the cream of the business to the large operators.” What do you think troubled the Court?
    2. Are there other explanations for these contractual terms? Specifically, why is it advantageous both to Ellen and to Danny for Ellen to have discretion about which movie to show?
20. George Lucas and Bargaining Power
    1. After the *Paramount* decision put an end to “the studio era,” contracts allowing talent to participate in the studio’s profits became more common. Before we turn to the standard contracts, let’s start with an arrangement that was unusual: George Lucas’s contract with Twentieth Century Fox to make *Star Wars.* (Some answers are not in the reading.)
    2. Initially, Lucas had a contract to make two movies. What were they? How much was he going to get paid for the second movie?
    3. What happened to give him more bargaining power?
    4. What did his agent suggest as a way to use this bargaining power? What did he do instead?
    5. Why was the studio willing to accept his suggestion?
    6. How did Lucas’s deal compare with the deals struck by other successful writers and directors? Was Lucas’s main motivation money or something else in making this deal?
    7. Was Lucas able to negotiate a similar deal when he and Steven Spielberg teamed up to make *Raiders of the Lost Arc*? Why or why not?
    8. Years later, Lucas sold his rights to the movies to Disney. How much did he get in return?
    9. Based on your answers above, what general lesson about bargaining power can we learn from Lucas’s negotiation with Fox?
21. Incentive Compensation
22. There are two types of contingent payments in Hollywood. Which is better and why?
23. Peter, a producer who works for Studio, negotiates a net profit interest with Wilma, a young screenwriter. You are a college friend of Wilma’s parents, and a Hollywood veteran. At her parents’ suggestion, Wilma meets you for coffee to ask for your advice. “This is my second movie. My first did well, so I’m getting $50,000 for this script, which is a lot more than the $10,000 that I got for my first script. Obviously, that’s good news,” she says. “They also are giving me a net participation, but my friends tell me that it’s unlikely to pay off in the end.” Is she right? What does Goldberg say about that?
24. “The net profits formula is really unfavorable to me,” Wilma says. “My friends say that this is just a sign that Peter drives a hard bargain. Studios will cheat us whenever they can, right?” Do you agree that bargaining power explains the net profits formula? (Hint: Goldberg is skeptical about that. Why?)
25. In predicting whether Wilma’s net participation will yield a generous payment, you obviously need to make a judgment about whether the movie will be successful. Assume for the moment that it will be (a strong assumption, to be sure, but please make it anyway). For you to advise Wilma about her chances of getting paid, what question should you ask her? What else do you need to know? (Hint: This information is not about Wilma, but about other people.)
26. Wilma asks whether Peter also gets a net profit participation, and you confirm that he probably does, given the standard contract structure in Hollywood. You also mention that Peter is likely to have an “overbudget penalty clause.” What is that? According to Goldberg, what function does the clause and Peter’s net participation serve?
27. Three weeks later, Wilma calls you and says, “Peter has just signed a really big name–Alicia Actress–as the star of the movie, but I’m not sure whether to be happy or sad about this.” What is the downside for Wilma?
28. “Keep in mind that Peter is in the same boat as you,” you respond. “In any event, I still think this is good news for you (and for Peter as well).” Please explain your statement. (Hint: Goldberg supplies the answer.)
29. Don’t Alicia’s gross points reduce Peter’s incentive to control costs and do his best work? According to Goldberg, why is Studio willing to dilute Peter’s incentive in this way?\After the production of the movie is complete, what additional steps can Alicia take to help it succeed? How, if at all, does a gross participation motivate her to take this step?
30. A film without a big star like Alicia can’t depend on the step in “i” to generate interest in the movie. According to Goldberg, when this is the case, whose efforts become more important in marketing it? Does the typical deal structure for a deal without a big star create the right incentives for others to step in and do more?
31. Does Goldberg think that the use and structure of net and gross participations can be explained mainly as a response to incentive problems or to asymmetric information?
32. Wilma calls you up a year later. “My last movie was a big hit, but my net participation didn’t pay off. I’m pretty annoyed about that,” she says. “Peter (who produced that movie) just called me, asking me to do another script. He’s offering me $100,000 for it and another net participation.” After you congratulate her, she poses a question: “This time, should I insist that the studio can’t grant anyone a gross participation?” What is your advice for Wilma? Why might this strategy backfire? (Hint: Again, Goldberg supplies the answer.)
33. A Critique: Monitoring and Incentives
34. Paula, a producer, is negotiating to sign Andrew, an up-and-coming actor, to work on a movie. The movie will be directed by Delia, a prominent and experienced director. Andrew receives a net participation. Does he need it to be properly motivated to do a good job? One potential rationale would be that his effort is not observable. If others can’t tell whether he is really trying, he needs to be self-motivated. But can’t Delia (the director) tell whether Andrew is making an effort and doing a good job? Also, doesn’t Andrew have other financial incentives to do his best work? What is Weinstein’s view on this issue?
35. Ned, whose novel is being adapted for the screen to make this movie, is also receiving a net participation. Ned wrote the novel five years ago, and someone else is writing the screenplay. How important is it to motivate Ned to do good work? Is the rationale for his net participation an incentive-based rationale? What is Weinstein’s view?
36. In the studio era, actors were permanent employees at studios. But since the studio era ended, they are hired only for a specific picture. What effect, if any, might this change have on an actor’s incentives to do her best work on a given movie?
37. If the success of movies is hard to predict, one possible response is that producers and talent will invest time and effort in making better predictions. Alternatively, another response is to use profit-sharing contracts. How can net and gross participations help the parties respond to uncertainty?
38. Recall that Arthur DeVany says that the success of movies is hard to predict, since it depends on the (unpredictable) reaction of audiences, as well as other factors (e.g., weather on opening night, what else opens at the same time, whether tastes have shifted, etc.). If DeVany is right, does this make incentive compensation more or less important?
39. If incentives are not so important, another potential rationale for net and gross profits interests is for movie studios to share their risk–specifically, the uncertainty about the potential box office success of the movie–with the talent.
    1. Why might studio managers favor this practice?
    2. Why might diversified shareholders in movie studios object to this practice?