

New Ways To Approach Negotiating TV License Fees

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Profit-participation licensing deals for TV shows are under scrutiny today. “The Walking Dead,” “Bones,” “Supernatural,” “Home Improvement,” “Who Wants to Be a Millionaire?” — each of these TV shows has been subject to lawsuits alleging that its broadcast TV licensing fees did not reflect its fair value.[1]

For example, after three years of arbitration and mediation in the “Bones” case, Fox Corp. was ordered to pay \$51 million over allegations of “self-dealing” in profit participation.[2] After five years, “Walking Dead” creator Frank Darabont will get his day in court in his \$300 million case against the show’s broadcasting network, AMC Networks Inc.[3]

The hefty stakes and uncertainty surrounding these matters are notable. The world of streaming programming is also subject to this dynamic, as the Writers Guild of America recently challenged Netflix Inc.’s license fees for streaming its self-produced films on its own platform.[4]

The circumstances that give rise to controversy in these examples are consistent: The studio that owns the rights to the show and the affiliated distribution network that distributes the show are both part of the same corporate entity. Because of this corporate relationship, when a licensing fee is negotiated between them, these fees are not generally arrived at through a market-driven process (an “arm’s-length” negotiation), and yet there is an expectation at least on the part of the litigants that these licenses should be on comparable terms.

The core of the dispute therefore is over how the fair value of such licenses should be determined when the rights owner (e.g., the studio) and the licensor (e.g., the broadcaster or streaming service) are both part of the same parent entity.

A Proposed Alternative

Applying international transfer pricing methods to estimate arm’s length TV licensing fees may make sense for these types of disputes. Transfer pricing issues are pervasive in multinational corporations and sometimes lead to tax disputes between a taxpayer and



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taxing authorities in the countries in which they operate.

For example, as part of their operations, multinational corporations routinely transfer rights to use their patents, brands or other intellectual property to subsidiaries located in different jurisdictions. The patent's transfer price is the amount paid by one related company to another for the economic rights to the patent. Because these transactions occur between related entities, the exchange may not reflect a market price or an actual transfer of funds.

However, in order to levy taxes, taxing authorities typically require some sort of market-based (or equivalent) measure of the transfer of wealth, which is known as the arm's length transfer price. The valuation methodologies used in tax disputes to determine an arm's length transfer price may also be useful for determining TV licensing fees between corporate siblings.[5] This is because in many such arrangements, a market price similarly is not otherwise apparent, and there may not be an actual transfer of funds.

Below, we describe two transfer pricing methods — transactional methods and profit-based methods — that may be applicable to establish arm's length prices for exchanges of intellectual property, like TV shows, between members of the same corporate family. These methods establish pricing by referencing observed behavior among unrelated parties in the open market for either comparable products or services (i.e., prices between those dealing at arm's length of one another), or comparable functions (i.e., profitability of similarly situated entities in the marketplace).[6]

For instance, prices that would occur in transactions between nonaffiliate entities in the market can serve as benchmarks for what a fair price would look like for an exchange between affiliate entities. Alternatively, profits attributable to sufficiently similar functions can serve as benchmarks for what an affiliate would earn if it were operating as a stand-alone entity in an open and competitive market.

The Transactional Method

The transactional method of transfer pricing compares the price charged between the affiliates to a price that would be charged between an affiliate and an unrelated party, or between two unrelated parties, for comparable properties under comparable circumstances. Both of these conditions must be met.[7]

For example, the "Walking Dead" dispute brought in potentially comparable transactions, including payments made by the AMC Network for the television shows "Better Call Saul" and "Mad Men." [8] The fees by AMC for these shows were paid to nonaffiliated producers Sony Corp. and Lionsgate Entertainment Corp., respectively, and, as such, may have reflected the true "market price" payment for the right to air "The Walking Dead."

However, the degree of comparability of the fees paid for "Mad Men" and "Better Call Saul" would have depended on the similarity of the circumstances at the time when the fees were negotiated. For example, one would have to investigate whether the creators of "The Walking Dead" had a similar ex-ante expectation of success to the ex-ante expectations for both shows "Better Call Saul" and "Mad Men" when each of their respective fees were negotiated.[9]

The Profit-Based Method

Alternatively, profit-based methods of transfer pricing compare the profitability of comparable firms

under comparable circumstances. For example, it has been reported that Netflix buys shows at a 30% premium over the cost of production.[10]

This is analogous to a “cost-plus” method that sets transfer prices by adding a market-based markup. The cost-plus method aims to ensure that the firm earns the same level of profits observed in the market for comparable firms. If nonaffiliated studios that sell content to Netflix earn profits of 30% over cost, then the profit level of these studios may serve as a benchmark for what sort of profit level an affiliated studio would earn under arm’s length circumstances.

These are only two of many recognized approaches for estimating transfer prices that may be viable methods for evaluating licensing fees for intellectual property between corporate siblings. If litigation related to what constitutes fair value in the context of media licenses becomes more common, it may prove valuable to borrow from a framework that has been effective in resolving disputes in the setting of transfer pricing. Transfer pricing methods that rely on benchmarking analyses may be a superior tool to evaluate fair value in such disputes — or even to avoid such disputes in the first place if applied when contracts are written.

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[1] “The Walking Dead”: Eriq Gardner, “‘Walking Dead’ Co-Creator Frank Darabont’s \$280M Suit Against AMC Headed to Trial,” *Hollywood Reporter* (December 10, 2018); “Bones”: Mike LaSusa, “Arbitrator Says Fox Dug A \$179M Grave In ‘Bones’ Profit Row,” *Law360* (February 27, 2019); “Supernatural”: Eriq Gardner, “A ‘Supernatural’ Profits Fight, and the AT&T-TW Merger Issue That Few Are Discussing,” *Hollywood Reporter* (November 17, 2017); “Home Improvement”: Lauren Berg, “Disney Seeks To Trim Suit Over ‘Home Improvement’ Contract,” (April 2, 2019); “Who Wants to Be Millionaire?”: Eriq Gardner, “Disney Appeals \$319 Million ‘Millionaire’ Verdict; How It Hopes to Overturn the Ruling (Analysis),” *Hollywood Reporter* (July 28, 2011).

[2] Craig Clough, *Fox Inks Deal With ‘Bones’ Stars, Producers In Profits Fight*, *Law360*, (September 12, 2019)

[3] Haily Konnath, *AMC To Face Ex-‘Walking Dead’ Exec’s \$300M Royalties Suit*, *Law360* (December 12, 2018).

[4] “Because these residuals are based on licensing fees, the WGA is challenging Netflix over how much it paid itself to license these films to stream on its own platform – a dispute that could have repercussions for Amazon, Hulu and Apple, which also release their own original films in theaters to garner awards attention.” See David Robb, “WGA Files Arbitration Claim Against Netflix Over Residuals From 33 Original Films,” *Deadline* (March 6, 2019).

[5] Litigation arises in this context because one or both entities have outside investors, or are required to treat non-affiliated parties fairly. Taxes at the state level may also lead to pricing dispute.

[6] U.S. transfer pricing methods under Treasury Regulation Section 1.482. Profit split methods (where profits are split, not benchmarked) are available to allocate returns between transacting entities when unique and valuable contributions are made by multiple parties, operations are highly integrated, and there is a shared assumption of economic risks.

[7] A number of factors are relevant when contemplating comparability. Ultimately, if sufficiently comparable benchmarks are identified, adjustments may be applied to account for slight differences in economic circumstances. Notably, if the transactions being analyzed have unusual characteristics and are not likely to competitively supplied, other transfer pricing methods are typically considered under such circumstances.

[8] Robert Kirkman, et al. v. AMC Film Holdings, et al., Case No. BC672124, Superior Court of the State of California, County of Los Angeles, Central District

[9] As a spin-off of AMC's huge success "Breaking Bad," fees negotiated for "Better Call Saul" may have been influenced by the expectation of an established audience. "Mad Men," launched three years before "The Walking Dead," cost AMC about twice as much as it earned in advertising even though it was widely seen as a critical success. It may have been possible to argue that AMC's experience with "Mad Men" had dampened their expectations regarding "The Walking Dead" and thus the ex-ante negotiation perspectives for the two shows may not be comparable. See Amanda Lotz, "How Profitable Was AMC's Mad Men?" Medium: The Outtake (May 15, 2015)

[10] Michelle Castillo, "Netflix tries a different model for TV shows, paying more up front but keeping more later on big hits, insiders say," CNBC (August 15, 2018)