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Liyuan Wei,

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## Invited Commentary

Making Sense of These Million-Dollar Babies—  
Rationale Behind Superstar Profit  
Participation Contracts

Liyuan Wei

Department of Marketing, City University of Hong Kong, G7353, 7/F, Green Zone, Academic Building, 83 Tat Chee Avenue,  
Kowloon Tong, Hong Kong, liyuan.W@cityu.edu.hk*Key words:* motion pictures; contact theory; talent compensation contracts; profit participation

The article by Eliashberg et al. (2006) provides a comprehensive review of current research on the motion picture industry, with a special focus on managerially relevant issues on the supply side. It walks the readers through the three distinct stages in the movie value chain of production, distribution, and theatrical exhibition, and it points out promising avenues of future research.

The contractual issues between talents and the studios in the motion picture industry are both diverse and complex. Currently, two forms of talent contracts are used: one with fixed payment only and the other with both a fixed component and a profit-sharing component (e.g., a percentage of the movie's net profits or gross revenues). Profit-sharing contracts have become more common in the past 50 years.<sup>1</sup> The enormous amount of compensation generated from such contracts for the superstars is illustrated in a recent lawsuit filed by Peter Jackson, the star director/co-producer of the *Lord of the Rings* trilogy, against its distributor New Line Cinema (*The New York Times* 2005). Mr. Jackson reportedly receives around \$200 million, 20% of the gross revenue for the trilogy, which has generated over \$4 billion. Despite this, he claimed that the distributor underpaid him \$100 million for the three movies by conducting self-dealing and preemptive bidding for subsidiary DVD and merchandising rights. Both anecdotal evidence

and empirical studies have shown that they have remained a privilege of the superstars, not the lesser-known ones (*Slate* 2005, Sisto 2003, Watson 2004, Chisholm 1997). The rationale behind this observation is not yet fully understood, however.

In this commentary, I discuss the contractual issues in the movie industry from both the actors' and the distributors' perspectives in light of what we know from contract theory.

**Actors' Motivation**

**Rent Capture.** Stars—who might be actors, directors, and producers—share certain common characteristics that can be used to measure their value, such as experience, awards (or nominations), recent participation in financially successful movies, and an audience following. It has been shown that, in a successful movie, stars are able to capture the best estimate of their added value (e.g., Rosen 1981, Ravid 1999, Chisholm 2004). The optimal way to recognize a star's marginal value to the movie's financial performance is to grant her a share of the revenues earned. On the other hand, the less well-known talents do not add as much value to the movie's finances; their contributions are not high enough to warrant profit participation (De Vany and Walls 2004).

**Screening Potential Projects.** Another conjecture is that stars use the two-part contracts as a device to screen potential movie projects (Weinstein 1998). Big stars tend to have higher opportunity costs than lesser-known talents; hence, evaluating potential projects is more important. The two-part share contracts provide both a fixed guarantee for them to get

Although invited commentaries are not formally peer-reviewed and represent the opinion of the author, authors were carefully chosen based on their outstanding expertise in the areas of their respective commentaries.

<sup>1</sup> Weinstein (1998) presented an excellent overview of the historical development of sharing contracts.

their reservation income and a possibility to be compensated proportionally to their added value. Thus, it simplifies the task of project evaluation.

## Distributors' Perspective

**Risk Sharing.** As is standard in the literature on state-contingent contracts, the profit-sharing contracts represent an optimal way for the signatories to share risk. Superstars are both a “bankable” asset and a potential liability for the studios. They are costly to recruit, but their attachment to a production increases the probability of financial success and reduces the financial risks—at least *ex ante*. Would-be blockbuster movies tend to have a larger budget and invite more stars. By sharing the profit outcome of the movie with the superstars, the studios shift part of the risk of failure to the superstars, who are themselves a major part of the staggering production cost.

**Defer Sunk Costs.** Because the talent costs are a major part of the total production costs for a movie, contracting such costs as a percentage of realized revenue is converting fixed costs into variable ones. The key to the share contract is that it is signed *before* the production starts. By granting a part of the talent costs as *anticipated* costs rather than upfront payments, the producer reduces sunk costs before negotiating distribution contacts with distributors. The higher the production costs, including the talent costs, the more important it is to secure a profitable contract with distributors. Profit-sharing contracts are said to improve the production team's bargaining position *vis-à-vis* pivotal distributors by shifting costs to the “back end” (Raskovich 2003).

## Future Research Directions

Many questions remain to be answered in this line of research, and I will briefly outline a few recommended areas. First, the idea behind the share contract is to pay the expensive superstars in accordance with their marginal contribution, or value-added. However, how to determine such value-added has remained unclear. Presumably, both the stars' own characteristics and the movies' characteristics may interact and affect the financial outcome. Moreover, participation of a superstar in a movie may have distinct profit implications for the theatrical release and the subsequent revenue sources, such as foreign market releases, TV rights, video sales, etc. (Elberse and Eliashberg 2003; Hennig-Thurau et al. 2001, 2003). For example, star power is more significant when the film has just been released because it serves as a brand, and not much other information is available; in the

video market, however, the film's appeal and quality have become much better known. The star's participation might not be that important in consumers' video rental or purchase decisions.

Second, is the relationship between the talent and distributors a standard principal-agent one? Weinstein (1998) did not think so, and he argued that superstars do not negotiate with studios but with studio executives, who, as managers, are so concerned about their own careers that they are more risk averse than the superstars themselves. A somewhat related argument by Watson (2004) suggests that, between superstars and the studios, the superstars, as key creative suppliers, are the dominant party in the bargaining process. The two-part profit-sharing contracts are the result of the stars' strong bargaining position, because they are able to shelter the stars from any risk. The validity of these conjectures remains to be tested.

Third, in the economics literature, the state-contingent contract is considered to be the optimal form to achieve optimal risk sharing. However, whether this purpose can be realized depends on if the “state” can be measured and verified (Allen and Gale 1992). In the film industry, the studios are both the bookkeeper and the residual claimer (Caves 2003) and are notorious for manipulating the accounting, which makes them subject to severe moral hazard concerns. The extremely complex composition of revenues and production expenses increases the monitoring cost and exacerbates the problem (Sisto 2003, Watson 2004). The fact that the media companies that own the studios are heavily integrated only makes things worse. In the lawsuit filed by Mr. Jackson, New Line (a subsidiary of Time Warner) sold the foreign market release to Warner Brothers International (another Time Warner subsidiary) at a cost allegedly lower than market level. Although this is in the best interests of Time Warner, the movie's profits on which Mr. Jackson's compensation is based are hurt. Therefore, for the studio, the profitability of the entire media conglomerate overrides that of the one particular film. Had Mr. Jackson's contract consisted of only a fixed fee, he would not have cared about the overall profits related to his trilogy, nor how and to whom these rights were sold—the vertical corporate structure would not have been his concern. In this sense, the impact of vertical integration of these media conglomerates on the talent compensation is only possible through the use of profit participation arrangements.

## Conclusion

The contractual relationship among the various members in a movie production team and between them and the studios (serving as distributors) constitutes

an intriguing area for research in marketing. Its many idiosyncrasies have not been sufficiently understood in the existing literature. For instance, the movie industry is characterized by “symmetric ignorance” that neither the studios nor the production team have better information on the success probability of a movie production (Caves 2003). The standard principal-agent theory has focused more on the single-sided information asymmetry and could be extended to capture this feature. On the other hand, such relationships also have a great deal in common with seller-buyer relationships in other industries with demand uncertainty, making it possible to test predictions from existing contract theories using data from the film industry. The superstars’ willingness and ability to sign profit-sharing contracts with distributors might be a good starting point because it touches on the important issues of risk attitude, bargaining positions, and more. More importantly, by addressing these managerially relevant questions, marketing researchers can help the industry make better-informed decisions and create a sequel to the famous line, “Nobody knows anything,” by the screenwriter William Goldman, to “Somebody knows something.”

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