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Contracts Between Art and Commerce

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Economists interested in the creative industries like arts and entertainment have had trouble mobilizing a set of economic tools suited to understanding such issues as why these industries are organized as they are and what consequences public policies hold for them. However, some useful tools have recently emerged from the theory of contracts. The basic structural characteristics of creative industries—their technologies of production and consumption—fiercely resist governance by anything approaching a complete contract. Yet they have evolved distinctive and serviceable contract forms that seem to differ from deal-making patterns prevalent in other sectors.

Great works of art may speak for themselves, as connoisseurs declare, but they do not lead self-sufficient lives. The inspirations of talented artists reach consumers' hands (eyes, ears) only with the aid of other inputs—*humdrum inputs*—that respond to ordinary economic incentives. The visual artist needs a gallery to display and promote works to potential purchasers. The author requires a publisher, the pop musician a record label. A symphony orchestra or dance company wants a hall and someone to market the tickets. The Hollywood movie, the Broadway play, the TV sitcom—each demands a diverse group of creative talents as well as a set of humdrum inputs. The question of how contracts work between art and commerce thus is nested within the larger question of why artists and humdrum inputs choose to structure their relationships as they do.

It turns out that the organization of the arts and entertainment industries depends heavily on the contracts that link creative and humdrum agents. These contracts vary in form, but all depend strongly on a common set of basic structural

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properties.[1] All fall some distance short of the theoretical ideal of a complete contract that prescribes the signatories' actions in all possible states of nature. But all do seem to share a "best-feasible" property that leads the deals struck in diffuse sectors to exhibit common features.

The Basics: Bedrock Structural Properties and Contract Theory

Several bedrock structural properties seem to underpin the organization of the creative industries. They also distinguish arts and entertainment from other economic sectors and, in some cases, distinguish between groups of these activities.[2] Each property gets an identifying catch phrase.

Nobody knows refers to the fundamental uncertainty that faces the producer of a creative good. All inputs must be incorporated and the good presented to its intended customers before the producer learns their reservation prices. Producers make many decisions that affect the expected quality and appeal of the product, yet their ability to predict its audience's perception of quality is minimal. Producers know a lot about what has succeeded in the past, and they constantly try to extrapolate this knowledge to the project at hand, but these efforts achieve minimal predictive value (Goldman, 1984).

That *nobody knows* would matter little if the inputs to a flopped creative effort could be salvaged and reused. However, the ubiquitousness of *sunk costs* denies the producer that protection. A creative good's suppliers must snag enough rents from each hit to cover the losses on several flops.

Another fundamental property lies in the attitudes of artists toward their work. *Art for art's sake* invokes the utility that the artist gains from doing creative work. Economists normally assume that work occasions disutility. However, artists may accept wages for creative work that fall short of their opportunity cost in humdrum employment, which means that artists can be viewed as a source of cheap labor. *Art for art's sake* also embraces artists' tastes as to *how* the creative work is to be performed, the technique or style to be employed. The artist's preferences over how to execute creative work complicate the contracting process, particularly the definition and allocation of decision rights.

Other basic properties involve horizontal and vertical differentiation, temporal coordination, durability and the hazards of coordination when several artists must collaborate. These properties will be introduced as needed.

To understand how these properties shape the deals that govern creative

[1] Indeed, some economists would roll professional sports into the package. This scope is customary in the legal field of entertainment and sports law (Weiler, 1997).
[2] This approach is developed in more detail in Caves (2000, especially the "Introduction").

industries' operation, we draw heavily on contract theory.[3] Here we flag some points of connection between contract theory and the conditions of creative industries. First, contract theory pays much attention to asymmetrical information, which usually involves a situation in which the seller knows key characteristics of the product not known to the buyer. However, in creative industries *nobody knows,* and the core problem is one of symmetrical ignorance. Second, while principal-agent relationships are important in creative industries, many deals in creative goods involve joint ventures between symmetrically placed suppliers of diverse inputs. Third, production in creative industries commonly involves inputs attached in technologically determined sequences: a movie director cannot plan the shooting until the screenplay has been finalized. Critical problems then arise of assigning and transferring decision rights as the project passes from one input supplier to the next.

Bilateral Deals: Artist and Facilitator

We start with deals of the joint-venture variety, involving one artist and one humdrum party able to bring the artist's inspiration to potential consumers. Examples of such a deal include visual artist and art dealer, author and publisher, musician and record label. The contracts observed in each of these settings illustrate how the bedrock structures of creative industries shape the structures of deals.

Visual Artist and Art Gallery

The relationship between artist and art gallery may seem the simplest of economic transactions, yet it is rendered complex and problematic by the bedrock properties. *Art for art's sake* carries a career twist evident from young artists' training and apprenticeship. The nineteenth-century romantic ideal sets the artist's task: to seek new problems of creative visualization and devise compelling solutions. Art progresses through a dialogue of problems, solutions that point to new problems and so forth. The artist, engaged in this dialogue, takes satisfaction from the work itself and not the acclaim (if any) that it elicits. Art is not craft or mere decoration. The training of visual artists instills these attitudes and evaluates the student according to creativity or originality, and not skill or proficiency (Getzels and Csikszentmihalyi, 1976).

The romantic ideal explains why artist and dealer agree on the long-term joint venture that we commonly observe. The artist enters into a protracted partnership with a dealer. The dealer will display the artist's work and articulate its problem-solving context and evolving meaning to collectors and others. This kind of contract dominates the distribution of "serious" contemporary art. Within it, the

[3] Milgrom and Roberts (1992, chapters 3–7) provide a useful introduction to contract theory. The contrast between contracting practices in creative industries and the preoccupations of contract theory need not imply a parallel contrast to the contracting practices in other industries.

artist can plausibly be true to the romantic ideal. No form of vertical integration of the production and distribution of art can preserve this ideal. If the dealer hires the artist to paint what the dealer thinks will sell, creative autonomy is clearly gone. If the artist undertakes the dealer function, haggling over prices with the customers, time making art is lost, and the artist must struggle with tasks that are both uncongenial and unfamiliar.[4]

The joint venture between dealer and artist involves a contract in which the artist prepares work for periodic gallery shows. The dealer undertakes to promote the artist's work with collectors, critics and curators, and the two parties divide the gross revenue (perhaps after certain costs are allocated to the artist) with the dealer claiming up to 50 percent. The contract (often done on a handshake) has no explicit duration; if the artist's work evolves in directions unappealing to the dealer, or clashing with the general style represented by the dealer's gallery, the two parties may go their separate ways.

The division of gross revenue, rather than profit, is a noteworthy feature of this contract. It likely reflects the nonobjectivity of measuring economic profit and the opportunism of the party serving as bookkeeper (a theme that will recur in the subsequent discussion of motion pictures). A joint-venture contract with profits split (say) 50-50 has certain attractive, if suboptimal, incentive properties. Each party captures a substantial if not a 100 percent share of any extra profit due to efforts that are not otherwise compensated directly. The contract offers the flexibility that reimbursed pecuniary costs can be assigned to either party.

On the other side, sharing revenue rather than profit depresses each party's incentive to incur mutually beneficial costs. It induces each party to try to shift costs onto the partner. Also, the contract encounters problems of moral hazard. With the dealer taking a large share of revenue, the artist and the collector acquire an interest in dealing with each other directly and appropriating the dealer's share; prohibition of direct sales is standard in artist-dealer contracts and its violation a common reason for termination. Moral hazard can also infect the dealer's bookkeeping; sales not immediately reported to the artist become interest-free working capital for the gallery, and lightly capitalized art galleries have disappeared overnight along with their artists' consigned works (for more detail, see Caves, 2000, pp. 21–30, 37–47).

Author and Publisher

The relationship between author and publisher is conceptually simpler than the artist-dealer alliance. The *art for art's sake* tastes of both artist and author orient them toward creating bodies of work over a lifetime career. However, the typical author finishes a book infrequently, which lowers the stakes for optimizing long-run future terms in the author-publisher deal. In trade publishing, the literary agent plays a distinctive role. A readily confirmed implication of *art for art's sake* tastes is

[4] These choices for the emerging artist broaden considerably for the established one, for whom exclusive representation likely loses its value.

that far more people invest in preparation for careers in creative work than can expect to earn normal pecuniary returns on their investments. Before any joint-venture contract unites art and commerce, some gatekeeper must judge which aspiring artist displays enough talent that humdrum resources invested in furthering it can expect a normal return. In trade-book publishing, the agent serves as marketer of the author's services to the publisher, and the author-agent deal precedes the author-publisher deal. The logic of the process is as follows.

The agent serves as a matchmaker, knowing what sorts of manuscripts will interest which publishers and able to discern and bring out merit in an author's work sufficiently that a publisher will recognize it. As the author's employee, the agent can elicit information relevant to the publisher: the author's flexibility, punctuality and other traits pertinent to successful collaboration. The agent tends to interact repeatedly with the publisher, which aids the credibility of the agent's recommendation. The agent, who is compensated by a share (traditionally 10 percent) of the author's royalties (Hepburn, 1968), will suffer from representing weak or uncooperative authors whose published work brings in little revenue. The agent with a poor track record for picking authors cannot earn a competitive income. Hence a publisher, expecting that the agent knows more about the author, may set aside suspicions of hidden negative information, because the established agent could not prosper on 10 percent of the royalty streams of weak authors.

The publisher's own contract is a revenue-sharing deal that awards the author a royalty expressed as some fraction of the book's wholesale or retail list price. If retail margins and the publisher's variable costs are taken as given, standard royalty rates split the publisher's gross profit (that is, before deduction of the publisher's fixed costs) around 58–42 percent between publisher and author (Auletta, 1997). As with other revenue-sharing joint-venture contracts, each party has only an attenuated incentive to exert joint-profit-maximizing effort. An important device for mending this defect is the author's advance. An advance is usually regarded only as working capital provided to the impecunious (liquidity-constrained) author. However, the publisher enjoys latitude on how much to spend promoting the author's book (a sum on which author and publisher seem unable to contract). Until the author's advance is recouped, the publisher pockets the whole extra dollar of profit due to any promotional effort, causing the profit-maximizing choice to be made. When the advance has been earned back, the publisher's incentive to promote again becomes attenuated.[5] This role of the advance illustrates an important general point about revenue-sharing contracts: a party's incentive can be intensified without upsetting the distribution of benefit between the parties by precommitting some outlay that the transferor can then earn back.

In literary circles, a debate proceeds over the publisher's attitude toward the agent's role. Trade publishers traditionally resented the agent's intrusion into the personal relationship between author (artist) and publisher (handmaiden), giving

[5] For other implications of the advance against royalties, see Hansmann and Kraakman (1992).

offense to the publisher's own sense of *art for art's sake* tastes. Furthermore, an agent likely strikes a better bargain for his authorial principal than could the author personally. Indeed, over the years, agents have wrested the control of subsidiary rights (such as paperback editions and movie screenplay rights) from trade-book publisher to agent and author. The publisher once staged subsidiary-rights auctions and pocketed half of the proceeds, but agent and author cannot be prevented from picking up any rents available in this way; after all, the author's talent is the one distinctive rent-yielding asset in play.

Against these invasions of the publisher's potential cash flow are stacked the advantages of the agent's services as gatekeeper. Without agents, publishers would incur the cost of gatekeeping—filtering the "slush pile" of manuscripts that arrive unheralded.

Musician and Record Label

The last of these bilateral contracts embodies a structure common throughout the creative industries—one turning on the problem of allocating decision rights efficiently. It retains the joint-venture form, but it adds the crucial element that the creative good's production proceeds in steps: one party supplies its input, sinking its cost in the process, then hands the incomplete good to the next party for attaching its input specialty. The pop music group completes the tape for an album, which then passes to the record label for manufacture, distribution and promotion. Since musician and label both seek an extended career for the musician, their obligations extend to the musician's future albums as well. A cinema film emerges from numerous creative inputs applied in sequence. *Nobody knows* the consumers' valuation of the end product, but completing another step in the sequence tends to reduce the uncertainty of the prediction. Each participant presumably knows more than anybody else about actions and consequences at the stage where its own input is applied.

Consider how these parties can manage the sequence of production steps to maximize the expected value of the end product. The first step has been completed by agent α (the cost of α's input is sunk). The next input supplier β is qualified to decide whether to continue by sinking the cost of the second input: β can observe the outcome of α's effort and holds the relevant information about the effect of adding its own input; nobody has better access to information about what state of nature will prevail upon the product's completion. Most important, β's input has not yet been sunk, giving it a strong incentive to be well informed. The expected value of the final product is raised if β obtains decision rights about whether and how to proceed. β, however, presumably maximizes its own expected returns from the project, which need not call for the same actions that maximize its total expected value. In particular, β has an incentive to act so that its second-stage decisions transfer benefits from α to β. A suitably foresighted α will of course anticipate this and demand a side payment from β to compensate for this moral hazard (Grossman and Hart, 1986).

The standard contract between record label and pop musician takes exactly this form. The label advances the musician a sum to cover the cost of recording the first album plus a negotiated amount of expected royalties. Upon delivery of the tape, the label holds the option to issue the recording. If the label exercises this option, the clock starts for the musician's delivery of a second album, which will bring a larger advance and higher royalty rate. Upon each delivery, the label decides whether to proceed. If one record's royalties fail to cover its advance, the shortfall becomes a charge against records issued subsequently ("cross-collateralization"). The options are one-sided, in that the musician may not quit the label and record for another until the contract expires—perhaps after a decade (Caves, 2000, pp. 61–64; Passman, 1994).

This contract has the efficiency properties previously noted. The musician or musical group spends its own advance money to record the album, so it has an incentive to use studio time efficiently (versus indulging in perfectionism). The label wields decision rights over distribution and promotion, which are its specialty. Furthermore, the contract's long duration warrants the label running losses on a promising artist's early albums. Despite this logic, public sympathy flows to the young musician who seems so deprived of decision rights and locked into a one-sided relationship. For example, musicians in California have sought to obtain legislation limiting the duration of record contracts (Ordonez, 2002); the backers appear to be successful musicians who would benefit from being able to renegotiate long-term contracts.

Why does not a kinder, gentler record label offer a short-term contract that lets the performer revel in the rents that come from a big, early success? The answer lies in the high "stiff ratio," the 80 to 90 percent of recordings that lose money. For the label to break even in the long run, it must mine enough profits from the successes to cover the stiffs' losses. Why is the artist without decision rights? Because, with *art for art's sake* tastes, any decision right retained by the artist threatens moral hazard and appropriation of the project's pecuniary value. In principle, the artist could bargain to retain some decision rights in exchange for reduced pecuniary compensation. However, contracting on creative decision rights is very problematic, and few examples come to light (one is the cinema film director's "first cut" in the assembly and editing of the raw film).

Complex Creative Goods with Motley Crews

Complex creative goods require several artistic talents along with humdrum inputs: cinema films, television program series, symphony orchestras, stage plays and repertory companies, dance troupes. Each is a complex institution with its own distinctive features. We focus on cinema and TV films and on how deal-making practice rests on underlying theoretical concepts.

Cinema Films

The long-standing Hollywood studios distribute and promote films, but each movie rests on a separate contract linking its producer to the actors, director and other key talents. The studio is intimately involved, though, when it finances the production cost of a film as well as distributing it (standard practice for big-budget films). Each studio carries out an intensive gatekeeping (filtering) process that keeps numerous projects “in development,” a purgatory in which interested parties rework and rewrite their projects to overcome studio skeptics and obtain the “green light.”

The producer as coordinator identifies and recruits the principal creative participants. Vertical differentiation plays an important role in this and other complex activities.[6] A creative good’s quality in the eyes of consumers can be increased by enlarging the fixed cost expended on it. These extra fixed costs might buy more elaborate special effects, crowds of extras and the like, but especially they buy more skilled (costly) creative participants. Those participants come ranked consensually within their creative communities—what is known as the *A-list/B-list* property. Films seem to aim for a consistent level of quality in their inputs. This practice might be attributed simply to complementarity among high-quality inputs: a better leading actress adduces a better performance from the leading actor. However, there seems to be something more involved than pair-wise complementarity. Every input needs to perform at least up to some level of dedication and proficiency to beget a work of unified quality. This requirement corresponds theoretically to the “O-rings property” of multiplicative production processes, named after a key component on the space shuttle Challenger whose failure contributed to the shuttle’s explosion: an output’s quality depends on all inputs performing up to some standard (Kremer, 1993). As predicted, A-list talents work with one another on film projects more commonly than would result from random assignment (Baker and Faulkner, 1991). That participants be available at the right time is another constraint on the assembly of projects, and it also feeds back to the process of putting the deal together. Committed participants incur sunk costs of negotiation and foreclosure of other opportunities, and so the last party to sign gains some strategic leverage to appropriate benefits expected by committed predecessors. Deal participants can keep this threat from their own doorways by demanding a “play or pay” contract, which guarantees one’s pay even if dismissed from the project or the film does not get made. Hold-ups of this and other types encounter a defense in the form of reputation in the film-making community, where word of uncooperative behavior spreads freely (as do consensual evaluations of A-list/B-list standings).

Pecuniary compensation in film contracts trades against other sources of utility to creative participants, which complicates the negotiation process. Compensation of stars includes a rent that (in principle) reflects the excess of expected gross revenue over what the film would earn with an ordinary talent in the role. Given the performer’s pecuniary rent (if any), the performer may also may trade off cash

[6] Vertical differentiation is product differentiation with the available brands uniquely ranked by quality. That is, everybody agrees that *A* is more desirable than *B*, *B* than *C* and so on, but they need not agree on their willingness to pay *A*’s higher price.

compensation for credit in a film that appears likely to garner critical esteem. Finally, up-front fixed compensation can be traded for deferred and contingent compensation, normally a share of either the film's gross revenues or its net profits.

Two questions arise about Hollywood deal practices. First, if screen talents are risk averse, their compensation must increase when it takes a contingent form. Giving the star a risk premium must generate offsetting value elsewhere. Two competing mechanisms that might do the trick include the incentive value of contingent compensation for getting (say) Sylvester Stallone to do his *Rocky* act once again and the reduction in risk premia demanded by other participants when risk is loaded onto the star. Scholars have addressed but not resolved these competing explanations (Chisholm, 1997; Weinstein, 1998; Goldberg, 1997).

The second issue lies in Hollywood accounting, which proves notoriously adroit at causing profits (that the studio must share with the talent) to recede into the indefinite future (Bibicoff, 1991). The types of costs invoked to devour any tendril of net profit generally have real economic bases. The trouble is that the studio distributing the film is both bookkeeper and residual profit claimant, subject to severe moral hazard (fraud, in the eyes of the victims).[7] A telling feature: net profit recipients may negotiate the definition of net profit to be employed. Contingent compensation hence tends to be keyed to gross revenue rather than net profits, with generally less satisfactory effects on incentives. This issue arises most notoriously in Hollywood, but the same problems of strategic accounting and moral hazard arise in all the creative industries.[8]

TV Program Series

The contracts that govern TV program series differ considerably from the contracts that govern cinema films. In viewers' eyes, the leading actors in a TV series become one with the characters that they play, and successful replacements are rare. If the program succeeds, the key actors gain strategic leverage to appropriate the program's profit by threatening to quit. Producers ward off this hold-up by insisting on contracts that bind key actors for long time periods. From the moment an actor first reads for a role in a new sitcom, the actor is committed to an option contract that commonly runs for five years. If the program is selected by a network and episodes are ordered, the producer and the network have the option at each season's end to continue the program and the actor's role. The renewal triggers a previously negotiated increase in pay, but far short of the rent imputed to the actor

[7] Why is the record keeping left with an intensely interested party? The only practical alternative would be the producer, who also takes a profit share and thus also faces moral hazard. Furthermore, the studio makes the key decisions about promotion and distribution. These it controls whether it keeps the books or passes the receipts along to another party.

[8] One reason why they arise is the sheer scale of the rents flowing to top talents in the creative industries—a pattern explained by the superstar effect (Rosen, 1981). Superstars' contracts differ from standard practices (as a rough generalization) more in the sums involved and the intensity of haggling than in the forms of contract structures. However, systematic differences do exist: superstars can forego cash for decision rights in pursuit of *art of art's sake*.

if the program is a big success. Consequently, when a successful program such as *Seinfeld* or *Friends* outlasts the standard contract duration, the star performer's compensation is up for grabs. The irreplaceable performers as a group then can claim the full rent expected to flow from subsequent episodes of the program (for example, Carter, 1998) and divide it among themselves according to bargaining power.

The option contract is accepted practice in TV broadcasting, but it clearly exacts its costs. Programs sometimes get cancelled because stalemates arise in renegotiating contracts. This outcome should not happen if all parties share the same expectations about the program's future cash flows, but they need not. The lock-in of actors to new programs distorts the planning process. The networks commission many more programs and pilot episodes than they will actually use *(nobody knows),* and many actors are committed to options that will not be exercised. A program selected by a network can sometimes "trade up" when a preferred actor previously committed to another program becomes available, but an optimal assignment of actors to roles is out of reach.

Future Research

Aided by simple contract theory, the patterns of deal making in the creative industries tell a rich story about how parties—both artist and humdrum—structure agreements to address complex incentive problems. One does not think of the arts and entertainment industries as sectors organized around sophisticated commercial contracts. Yet the very structural features that challenge economic calculation serve to explain why deals are structured as they are. Revenue-sharing joint ventures with up-front payments and real option contracts with successive transfers of decision rights make repeated appearances in the creative industries. A great deal of qualitative evidence supports these descriptive conclusions. However, we lack a deeper knowledge about the trade-offs and terms of these deals that could come from access to samples of contracts and their specific terms. Questions such as these might receive answers: To what degree are contracts formally binding in creative industries versus providing a basis for renegotiation when certain future states of nature emerge? How much of a role does risk spreading play in contracts in these highly uncertain markets, especially given artists' many forms of risk-loving behavior? In creative industries where some humdrum enterprises possess elements of market power, in what forms are these deployed in contracts with talent?

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