Conflicts of Interest in the Hollywood Film Industry:

Coming to America - Tales from the Casting Couch, Gross and Net, in a Risky Business

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1. Introduction

"It's very difficult to identify conflict of interest. Life is full of them." Warren Beatty, remarks following a Screen Actor's Guild meeting in Los Angeles, Feb. 22, 2000, James Bates and Claudia Eller, *Los Angeles Times* "Company Town: The Biz," C1 and C6.

Making a film is an uncertain enterprise, not just because of the fickleness of movie goers, but because of the immense complexity of the process. From its initial conception in the "pitch" to its ultimate exhibition at the movie complex or placement at the local video store, the coordination process in the making of a film is a team effort with enormous potential for economic dissonance. The Hollywood problem inheres in motivating the myriad of economic agents in this process - actors, agents and managers, directors, producers and

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other production talent, and writers, with marketeers and the all-important financial backers - to serve the collective interest of the enterprise, not just their narrower ones. For artistic as well as pecuniary reasons Hollywood film industry participants often have incompatible incentives.

One of the keys to understanding the Hollywood problem is that everyone's information is imprecise. Since post-contractual separation of what follows from chance and from chiseling in the making of a film is difficult, opportunism in this environment is commonplace, if not rampant. Well known, even to the lay public, are disputes over rights to "points" and to future syndication, profit-sharing controversies, allegations of the "casting couch" and other forms of favoritism or sexual harassment, failures to acknowledge the contribution of others in movie credits, and outright theft of concepts occasionally make the news in Middle America, but are quotidian fare in Daily Variety, Entertainment Weekly, The Hollywood Reporter, Premiere, and the "Company Town" column in the Los Angeles Times. Understanding these fractious linkages helps explain how from the 1920s through the 1940s the Hollywood Studio System (HSS) developed as an ingeniously economic way of harmonizing these disputes, albeit imperfectly.[1]

In this chapter we use the movie business as a case study to show how the potential for conflicts of interest in an industry is influenced in important ways by fundamental underlying properties of both the industry's production process and demand. We show how three key characteristics of the movie business - collaboration on a large scale, large up-front expenses, and tremendous uncertainty - have led to peculiar organizational and contractual practices. These practices appear to be non-competitive and even coercive in nature when they are viewed through an all-inclusive lens such as the Sherman Anti-Trust Act, which is designed to deal with monopolization issues in all industries and, therefore, leads courts to ignore or underestimate the importance of underlying fundamentals in any particular case.[2] We argue, however, that the unique and fascinating practices are reasonable responses to industry

[1] Imperfect may still be efficient, however, when given the costs of further improvement, the returns are unfavorable.

[2] As we write, the Microsoft case is underscoring the tensions between off-the-rack interpretations of law by the U.S. Department of Justice and Microsoft's team of lawyers and economists who wish to emphasize the idiosyncratic nature of the software industry.

conditions. The organizational and contractual practices that we describe are mechanisms that align the incentives of industry participants to prevent conflicts of interest, facilitate the acquisition of information, and insure against risk. Our analysis suggests that in order to properly understand, mitigate, and adjudicate disputes among professionals, it is essential to have an understanding of the industry conditions that lead to the disputes in the first place.

We approach the analysis of conflicts of interest from an economist's perspective.[3] Production and distribution involve more than a mechanical exercise in win-win cooperation. When parties to an exchange interact in the real world in a principal-agent relationship - stockholders with managers, managers with workers, customers with sellers, and so on - they seldom, if ever, have exactly the same goals. Conflicts of interest occur when a single agent has to use his judgement to either 1) balance the goals of two or more of his principals or 2) balance an interest of his own against the goals of one or more principals. Because parties to an exchange typically anticipate conflicts of interest, one of the goals in designing contracts and organizations is the minimization of such conflicts. Contracts provide agents with incentives to take appropriate actions. By doing so, contracts remove the need for a principal to trust the agent so much, because as long as the agent is self-interested, he can be expected to perform more as the principal desires. Organizations centralize decision-making and use authority relationships instead of relying on independent judgement.

Nevertheless, contracts are always incomplete and organizations are imperfect; economic agents always have some opportunity to chisel on the explicit and implicit conditions agreed upon. The way organizations develop and adapt to internalize these opportunistic proclivities is the subject of much of modern economic theory and is the economist's way of understanding how conflicts of interest are faced up to and mitigated (though never "solved") in the contractual process.

In what follows, we begin by describing the key characteristics of the movie business that shape the rest of our discussion and then describe how industry participants have anticipated and mitigated conflicts of interest. We organize our discussion around the rise and fall of

[3] Conflicts of interest are implicitly dealt with in the neo-institutional version of economic theory (North, 1990) and game-theoretic models of agency problems (Mas-Colell et al. 1995).

the HSS.

Though the HSS emerged in response to industry conditions in the 1920s, several antitrust cases and consent decrees in the late 1940s and early 1950s led to the end of the vertical integration practices and the related contractual arrangements used by the major Hollywood studios in the glory days of the studio era. We describe how modern contractual arrangements between distributors and exhibitors attempt to accomplish the goals that the HSS was designed to solve. We then discuss the net-profits controversy, which has received considerable attention in the press and in the courts in several cases, including *Art Buchwald v. Paramount Pictures Corporation* (1990), and other disputes between various Hollywood participants. Finally, we describe the controversies surrounding the "casting couch."

2. The Movie Business

"A film brings together a combustible partnership of ideas, skills, and temperaments.. A tightly controlled bottom line is for the most part an impossibility." David Puttnam (1998), p. 4.

Three key characteristics of the movie business have not changed since the emergence of the full-length motion picture in the early 1900s (Robertson, 1991). First, financing, manufacturing, and marketing movies requires the collaboration of several economic agents, including creators, producers, financiers, writers, directors, actors, distributors, and exhibitors. Thus, movie-making is a team effort on a grand scale. To arrive at a rough estimate of the scale involved in a modern production, consider the following statistics: The Motion Picture Association of America (MPAA) reports that in 1998 a total of 490 new movies were released in the United States and 564,800 people were employed by the industry, with 240,200 employed in production and services, 133,500 employed in theatrical exhibition, and the remainder involved in video tape rental and other activities.[4] Although not all of the people employed by the industry are involved in making new movies, many are involved in several projects at once. The employment figures suggest that a typical project employs a very large

[4]All of the MPAA figures reported here and below can be obtained from the MPAA web site, http://www.mpaa.org.

number of people. Clearly each movie project requires a considerable amount of coordinated action.

The second key characteristic of the movie business is that movie-making requires substantial up-front costs that must be incurred before the final product reaches the market. Again, the MPAA provides useful statistics. The MPAA breaks costs down into several components. The first component is the "negative costs", the costs of manufacturing the master print. The negative costs include any up-front payments to writers, directors, actors, and other employees, costs for sets, and other costs incurred during the production process. If the movie is made by a studio (currently there are six major ones: Disney, Fox, Paramount, Sony, Universal, and Warner Brothers) then the studio also charges an overhead fee for use of its facilities. The studio also charges interest on the negative cost and the overhead. Other important costs include print costs (the costs of making copies of the movie to distribute to theaters) and advertising costs. In 1998, the MPAA estimates that the average movie made by one of its members had negative costs, overhead, and capitalized interest of $52.7 million, print costs of $3.2 million and advertising costs of $22.1 million, for a total cost of $78 million.

The third key characteristics of the movie business is that every movie is different, so at the financing stage there is tremendous uncertainty about demand for the final product. Therefore, movie making is a very risky business. When describing the movie business economists frequently quote screenwriter William Goldman who said, "Nobody knows anything." (Goldman, 1989, p. 39). Economists De Vany and Walls (1996, 1999) have shown that Goldman's statement is supported by the data. Using a sample of 2,015 movies released in the period 1984-1996, De Vany and Walls computed the cumulative box office revenues from the U.S. theatrical market for each movie. Using the cumulative revenues for each movie, De Vany and Walls have shown that the distribution of cumulative revenues is best-approximated by a Pareto distribution with an infinite variance.[5] This implies that if we think of each new movie as a random draw from the distribution suggested by past outcomes, then there is no way to forecast cumulative revenues. Since every forecast has a forecast error

[5]The Pareto distribution has a peak at a low level of revenue and is skewed to the right. When the variance is infinite, the right tail is very fat.

with an infinite variance, forecasts have no predictive power.[6]

Since financing decisions need to be made on the basis of little more than an idea (the "pitch"), it is quite reasonable to think of studio executives making financing decisions in an environment in which they are unable to forecast. In addition to De Vany and Walls' formal analysis, there are several examples in history of executives making decisions that after-the-fact appear to be huge mistakes. Vogel (1998) reports that Star Wars, the first movie in the most successful series ever (that includes Empire Strikes Back, Return of the Jedi, and Phantom Menace: Episode 1) was pitched to several studios before Twentieth Century Fox agreed to finance and distribute it. Titanic, the highest grossing movie of all time, and other successful movies including Back to the Future and Raiders of the Lost Ark were treated similarly. The list of poor box-office performers that generated tremendous initial optimism is equally impressive: Heaven's Gate, Howard the Duck, Ishtar, Pennies from Heaven, and Star! are prominent examples.

In addition, De Vany and Walls' results yield another stylized fact: the Pareto distribution has the property that the likelihood of observing any given level of revenue falls as the level of revenue rises. When combined with the result that cumulative revenues have an infinite variance, this implies that low revenue is the most likely outcome, but that when a hit occurs the upside has no limit. This result, when combined with the fact that movie-making involves large up-front costs, implies that many movies do not earn a positive return on investment. Although De Vany and Walls' data includes only the U.S. theatrical market, revenues in later markets tend to be in rough proportion to revenues in the U.S., so it is unlikely that

[6]It is important to distinguish between forecasts made at the financing stage and forecasts made once the master print is complete. Once the master print is complete studios can use test audiences to assist in forecasting, and even third parties like Premiere magazine can often compute accurate forecasts based on industry "buzz" about the movie (Shamsie, 1999). The problem is that at the financing stage, when the money must be committed to the project, there is no way to forecast.

As the idea is developed into a script and moves into production the studio's forecast becomes increasingly accurate. When improved forecasts are available the studio might reevaluate the project and shut it down. However, it appears that such shut-down decisions either occur before production has begun (in the development stage, when not much money has been committed) or not at all. Perhaps it is too difficult and expensive to transact with all of the resources required to make the movie if the studio retains the right to cancel or renegotiate all contracts once production has begun.

In any case, the pre-production forecasts, though based on a script instead of just a pitch, are also notoriously inaccurate. For example, Goldman (1989) reports that Columbia passed on E.T. after developing it for $1 million because a survey suggested the audience would be small. Universal picked it up and E.T. went on to become one of the most successful movies of all time.

the results would change if the other markets were included. Vogel (1998) claims, in fact, that most movies do not earn a positive return on investment even after taking into account home video, cable and television income and income from other sources. Thus, the few big winners seemingly pay for the many losers.

In the remainder of our paper, we use the three key characteristics of the movie business and their implications to explain both the organizational and the contractual forms in the history of the business. We show how the unique organizational and contractual practices adopted by the industry in response to the key characteristics mitigated several conflicts of interest but led to well-publicized legal disputes. In our analysis, we benefit from previous work by several economists and from various histories and commentaries on the industry cited in the bibliography.

3. Conflicts and Solutions in the Movie Business

"As Hollywood classics ... are recirculated and rediscovered by successive generations, it is little wonder that filmmakers would want to revive the system that produced them." Thomas Schatz (1998), p. 492.

3.1. The Emergence of the Hollywood Studio System

During the peak of the studio-era (roughly from the 1930s through the late 1940s), a few large Hollywood studios integrated finance, production, distribution and exhibition and dominated the industry. Each major studio had long-term exclusive contracts with its actors and other talent and owned its own first-run theaters. Unfortunately for the HSS, its highly hierarchical and economically successful structure - involving exceedingly long-term contracts for its numerous talent, and its putatively oligopolistic rather than atomistically competitive market - invited state intervention. In the late 1940s and early 1950s a series of antitrust cases and consent decrees collectively referred to as the Paramount decrees ensued, exceedingly adverse to the HSS. The 1950s also brought the rise of television, a potent substitute for theater screens, causing even more problems for the major studios. By the end of the 1950s the HSS effectively was no more. Hollywood itself was alive, however, and many of the major

studios remained, but their structures were hollowed out. Vertical integration and temporal relations were shortened up and scale was reduced. With the HSS gone, the market was formally more competitive, though whether more effectively so is a matter of controversy among scholars and industry insiders.[7]

In this section, we argue that the vertical integration and related contractual practices employed by the HSS were natural responses from firms that had to deal with the three key characteristics of the movie business described above. We show how the industry structure that resulted from the firms' choices led to legal disputes and explain why the courts were persuaded that many of the industry's practices were the result of abuses of market power rather than adaptive responses to fundamental underlying conditions. De Vany and Eckert (1991) have analyzed the events leading up to the Paramount decrees, and we build on their analysis below. Following our analysis of the break-up of the HSS, we describe how modern non-integrated studios deal with the problems that the HSS was designed to solve.

Our first point is that the HSS emerged in response to the key characteristics outlined in the previous section. The major Hollywood studios were a solution to the problem of coordinating large numbers of inputs and financing large, risky projects. Combining finance, production, distribution and exhibition in one organization and using long-term exclusive contracts helped the studios assemble the various participants in a project and align their incentives with the studio's. This mitigated conflicts of interest. In the movie-making process, famous actors have to balance their contractual goal of completing the movie and their private goal of gaining more recognition from fans and other studios. Actors may hold up production by demanding more lines to say or other types of special treatment. Famous directors have to balance their contractual goal to not spend more than the budget allows and their private goal of pursuing their artistic aims. Short-term contracts cannot align incentives in a satisfactory way because it is impossible to write a complete contract that specifies each party's rights and responsibilities in every possible state of the world.

[7] Although the decline of the majors gave way to the growth in numbers and relative stature of new studios and independent producers and distributors, agency costs and scale/scope economy losses necessarily rose. De Vany and Eckert (1991) argue that the Paramount decrees raised costs, reduced output, and ultimately hurt consumers. Whether the more recent mergers of studios and t.v. networks in entertainment conglomerates is a substitute for the defunct HSS is not at all clear, since these links are more horizontal than vertical.

By using long-term exclusive contracts studios were able to economize on the transactions costs (the costs of negotiating, monitoring, and enforcing contracts) associated with dealing with the many project participants. The ongoing integrated organization avoided the cost of recontracting every time a new movie was made, and could punish chiselers more effectively because contracts lasted beyond a single project.[8]

The large studios were able to produce several movies within one organization during a relatively short amount of time. This allowed the studios to overcome the financing problem described above, because movies in the theater provided cash to finance new projects. Other aspects of the organization of the HSS also contributed to resolving the financing problem. The studios needed access to screens in order to generate cash flow, and they used both contracts and integration to ensure access. Owning theaters provided the studios with insurance, since they could be sure of having access to the screens they owned. It also allowed them to more easily monitor box-office performance and learn about how successful their movies were.

Operating on a large scale was essential too, not only for cash flow purposes, but also to diversify risks in the movie-making environment. Since success is unpredictable in advance, in order for a production-distribution company to survive it needs many movies in order for the hits to make up for the "dogs" (industry parlance). Otherwise as time goes by the firm eventually experiences a string of dogs and must exit the industry. Several of the studios experienced ups and downs in the HSS era, and in modern times there are several examples of smaller studios and independent producers and distributors experiencing financial failure. Modern independents must experience success in their first few tries or go out of business (Levy, 1999).

In sum, the need for firms in the movie business to economize on transactions costs and diversify risks led to the emergence of the HSS, in which a few large vertically integrated firms controlled most of movie production and distribution.

[8] Authority and long-term contracts provided the studios with more control over budgets as well. It is interesting to note that modern independent producers often rely on "completion guarantors" to control budgets. Completion guarantors provide a form of insurance to financiers. They are paid a fee up front, and in return they agree to provide the funds to complete the picture if it goes over budget. Of course, this is an imperfect solution, because the completion guarantor may accomplish this budget-control goal by taking over the production of the film, and this can result in a poor final product (Squire, 1992).

3.2. The Organization of Theatrical Exhibition During the Studio Era

The theater system during the studio era was organized to allow for different "runs." Major motion pictures would open in first-run theaters, many of which were located in the downtown areas of major metropolitan centers. After showing in the first-run theaters, the movies would move to the second-run theaters, and later to third-run theaters. Then as now, movie attendance was typically highest in the first few weeks following the opening of the movie, so the first-run theaters were the plushest and most successful theaters.

Even during the peak of the studio era most theaters were not owned by the studios. Nevertheless, the studios did own several first-run theaters in major metropolitan centers, which allowed them to accomplish three main goals: First, as discussed further below, it made it easier for studios to manage the allocation of their movies to theaters. Second, the studios needed to generate cash flow as quickly as possible in order to finance their current production. Third, the studios needed to monitor box-office performance. Integration assisted the studios in planning the second and later runs of their movies by allowing the studios to obtain precise estimates of demand.[9] However, studio-ownership of first-run theaters created an environment in which the studios controlled many of the most successful theaters in the industry, and this led in part to the Paramount decrees in the late 1940s and early 1950s.[10]

The fact that studios and independent exhibitors could not predict the demand for each movie made it difficult to manage runs and release dates to maximize revenues while avoiding disputes. To see why, consider a simple scenario in which an exhibitor has a theater with a single screen. Suppose the exhibitor agrees to show distributor 1's movie A and then distributor 2 arrives with movie B. When should the exhibitor begin showing B and stop

[9] When dealing with independent exhibitors, studios sometimes employed individuals to count the number of patrons at a theater to monitor the box-office performance and prevent exhibitor chiseling. Also, exhibition contracts sometimes based the distributor's payment on the national revenues instead of the individual theater's revenues. This effectively severed the connection between the exhibitor's own revenues and the amount he needed to pay the distributor, and effectively removed the exhibitor's incentive to misreport his revenues.

[10] The Paramount decrees were, according to De Vany and Eckert (1991), brought on by the complaints of several independently owned theaters in major metropolitan areas who felt denied the right to show first-run studio-produced films: "During the 1950s, one-third of the correspondence received by the Antitrust Division of the Department of Justice was from exhibitors complaining about distributor decisions concerning runs, clearances, and criteria for selecting winning bids."

showing A? In a world free of transactions costs and with complete trust, the exhibitor could be a fiduciary of the distributors: the exhibitor could determine the switching point by maximizing the sum of the revenues from the two movies and then divide the revenues in a "fair" way between himself and the two distributors.

However, because in reality the distributors do not trust each other or independent exhibitors, each distributor uses a contract to restrict the exhibitor's behavior. A typical exhibition contract might specify a final showing date while allowing for possible renegotiation or continued showing if the revenues are sufficiently high. While these contracts avoid the need for distributors to trust the exhibitor, they may not lead to the maximum revenues. No matter which final showing date the exhibitor agrees to, there is a very high chance that after demand for A has been observed, the exhibitor will regret his choice. Renegotiation will be difficult, too, because in most cases any change that benefits distributor 1 hurts distributor 2 and vice-versa.

In order to attempt to maximize revenues while avoiding disputes some contracting practices emerged that were on their face unusual, but reasonable under the circumstances. When studios contracted with independent exhibitors, they typically used a block booking contract. The basic feature of such a contract is that the studio and exhibitor would sign a contract in which the exhibitor agreed to show all of the studio's movies during a season. Both sides benefited from block booking - the studios were sure of placing their products in the theaters, and theaters were sure of having something to sell. Further, block booking facilitated renegotiation. In the above example, if distributor 1 and the exhibitor signed a block booking contract, then if it became desirable to extend the run of one of distributor 1's movies, distributor 1 could agree to delay the opening of one of his other movies in the block. Since block booking was also typically combined with a revenue sharing agreement, both sides had the incentive to agree to the renegotiation as long as it increased total revenues.

Though it had some advantages, block booking appeared to be somewhat coercive, and some of the practices that accompanied it made it look even more so. For example, block booking was accompanied by blind selling: typically independent exhibitors had to accept films in the block without having the opportunity to screen the movies in advance. Each exhibitor would receive a list of the studio's movies with a basic outline of the plot, director,

and actors for each feature. Blind selling was necessary under the circumstances. In order for block booking to occur in the absence of blind selling, a studio would have to have its entire season of movies ready to be released at the beginning of the season. As mentioned above, movies have large up-front costs that cannot be recouped until the movie is released, so the opportunity cost of keeping a movie in inventory is quite high. The interest costs of keeping a movie in inventory would have to be passed on in part to exhibitors and consumers, so it was in the interest of everyone involved to keep such costs down.

Some of the problems that might be associated with blind selling were avoided by the HSS. For example, one potential problem with blind selling - essentially the selling of a product that does not yet exist - is that the seller may never deliver the promised good. Exhibitors might fear that the studio would promise a particular movie with particular stars and other talent and then fail to deliver. The Hollywood studios were able to avoid this problem because they were integrated into production. The studio system allowed the studios to credibly commit to making the movies on the list because all of the directors and actors were in the studio's stable of stars.

Further, Hanssen (1999) argues that block booking and blind selling in practice did not restrict exhibitor choice as much as they might have. A simple-minded interpretation is that the large powerful studios used the contracts to force the small independent exhibitors to take all of the bad movies along with the good ones, and to have no opportunity to screen the movies in advance. In reality the contracts were not so coercive. Exhibitors were typically allowed to refuse to show some percentage of the movies (perhaps 10 percent) once the movies were available for screening. The number of movies the exhibitor could refuse to show was agreed to by both parties in advance. Hanssen shows that exhibitors typically refused fewer movies than permitted under the contract, which suggests that exhibitors were not unduly constrained by these long-term contracts.

In sum, block booking and blind selling allowed distributors and exhibitors to deal with the tremendous uncertainty in the movie business. Since no one can forecast a movie's likelihood of success before it has been produced, all parties operate under a veil of uncertainty at the point of contracting when blind selling is used. Thus, overall risk is reduced to the extent that distributors can be sure of placing all of their movies in theatres, whether or not

they are hits, and exhibitors are assured of obtaining movies for their screens. Nevertheless, disputes can occur. Once demand is realized, the distributor would like to force the exhibitor to keep the dogs, but give up the hits so that they could be put up for competitive bidding! On the other side, in some situations the exhibitors might prefer to refuse more movies than they are allowed to by the contract. Given the obvious potential for disagreements after the movies have been released, it is easy to see why early on studios pursued vertical integration as a way to avoid endless contract negotiations and renegotiations and why long-term relationships were important.

3.3. The Collapse of the HSS

The fact that movie-making came to be dominated by a few large firms that integrated finance, production, distribution, and exhibition and used contracts that were integrative in nature made the movie business a target for the anti-trust authorities. The courts, unfamiliar with the details of how the industry operated and why its particular organizational forms emerged, applied a one-size-fits-all solution, the Sherman Anti-Trust Act, and decided that integration, block booking and blind selling involved an abuse of market power on the part of the studios. In a series of court decisions that began in the late 1940s and continued into the 1950s, the studios were forced to sell off their theaters and to stop using block booking and blind selling and other features of contracts that were integrative in nature.

In part as a result of the Paramount decrees, the HSS collapsed in the late 1940s and early 1950s. It is difficult to estimate the full impact of the decrees because the collapse of the HSS was in part due to the diffusion effects of television. In the 1950s, television became increasingly popular. With the advent of television, demand for "B" movies, which tended to have the same characters in similar stories again and again, dropped considerably, because people could get that type of entertainment on television for free. As a result, studios found it necessary to produce large blockbusters in order to attract an audience (De Vany and Eckert, 1991). Thus, studios began making fewer, but much bigger films. Once the studios stopped making B movies, it was no longer optimal to keep a large stable of talent on long-term exclusive contracts, because the talent could not be continuously employed.

Interestingly, even though industry conditions have changed somewhat, some modern

organizations still model themselves after the old studios when developing relationships with talent. For example, in the 1990s TriStar pictures maintained long-term relationships with several production companies. Generally, TriStar obtained exclusive rights to pictures the production companies generated for a given period, and the production companies benefited because they did not have to deal with a distributor each time they produced a picture (Squire, 1992). Also, modern multidivision talent agencies like the William Morris Agency, International Creative Management, and The Creative Artists Agency have taken the place of the old studios in many ways. The large agencies have long-term contracts with their talent and often do package production deals that combine several actors with a director. Further, in modern times, often a single individual is both the producer and star or director and star of a movie. The individual in the combined role may internalize many of the externalities typically created in the dealings between the artistic and business sides in the movie-making process.

The HSS eliminated much of the potential for conflicts of interest because throughout the vertical chain, from "pitch to popcorn,"[11] the movie business was dominated by the large studios. In the following subsection, we describe contractual arrangements in the post-HSS era that were designed to mitigate conflicts of interest in the absence of authoritarian relationships.

3.4. Post-Paramount Distributor-Exhibitor Contractual Arrangements

By the late 1950s studios still financed production and controlled distribution, but no longer owned theaters and no longer had long-term contracts with talent. However, the underlying key characteristics of the industry remained: the studios needed outlets for their movies, the exhibitors needed movies to put on their screens, and movie-making still involved tremendous uncertainty and large up-front costs. Integration of distribution and exhibition was no longer an option, and in any case with the advent of television may not have been optimal. It is interesting to consider the two solutions the firms adopted in lieu of integration.

First, short-term contracts replaced integration and long-term contracts as the means

[11] We thank our colleague Gary Segura for suggesting this catchy phrase.

of aligning incentives of the various parties involved. Since studios did not own theaters and could not use long-term contracts, they had to rely on short-term contracts to attempt to align the incentives of theater-owners with the studio. Second, long-term relationships developed that allowed the studios and the exhibitors to avoid much of the short-sighted non-cooperative chiseling that might otherwise have emerged. Today, most exhibitors are independent theater chains, so the large studios negotiate many of their exhibition contracts with these large firms. For the most part, even though contracts with exhibitors are on a movie-by-movie basis, distributors still maintain long-term relationships that help them resolve disputes.

Exhibition contracts vary from exhibitor to exhibitor and from movie to movie, but they generally have some features in common. Each week, the distributor gets the maximum of three possible payments. In the first, the distributor gets 90 percent of the movie's gross over some agreed upon "house nut," where the house nut is a fixed amount paid to the exhibitor. In the second, the distributor gets a "floor payment," some percentage of the gross that declines as the weeks go by. The share might start at 70 percent in the first week, be 60 percent by the third week, and eventually fall as low as 40 percent. In the third possible payment, the distributor simply receives a flat guarantee. For hits early on in their runs, the 90 percent over the house nut is the relevant payment. For most other movies the floor is relevant, and for complete failures the flat guarantee applies. Of course, if the distributor and the exhibitor have a long-term relationship, then renegotiation is possible in the event of a complete failure.

Although the courts were in favor of distributors relying on competitive bidding as a way to allocate movies to theaters, they realized that they lacked the resources to monitor the bidding process on a movie-by-movie basis, and so did not impose such a procedure on the industry. In modern times, the use of bidding varies by distributor and by region, but in general most exhibition contracts are negotiated with exhibitors (Squire, 1992). Even when competitive bidding is used it is not binding, and it often serves as a point of departure for negotiations between the distributor and the exhibitor. When evaluating bids, distributors consider a variety of factors other than the contract terms, such as the demographics surrounding the theater, the location itself, and the decor.

Filson et al. (2000) show that the short-term exhibition contract attempts to accomplish in a decentralized fashion many of the same goals that integration and block booking attempted to accomplish in the studio era. One of the main goals is the mitigation of exhibitor conflicts of interest.[12] To see how a short-term contract aligns the incentives of the exhibitor with the interests of the distributors, consider the problem faced by a modern exhibitor, who typically runs a multiplex (a theater with several screens). The exhibitor first must choose among the movies that different distributors have to offer and then must allocate movies to its various screens in a way that maximizes its revenue.

The exhibitor's revenue from each movie depends on its contract terms with each distributor for each movie and on the entire slate of movies it selects. To see why the slate of movies matters, consider a multiplex with two screens, and simply note that some movies are fairly close substitutes (for example, Horror A and Horror B), while others are not (Horror A and Drama C). Showing two horror movies at the same time attracts only those consumers who like horror movies (typically the under-25 crowd) and splits those consumers between the two movies, while showing Horror A with Drama C allows the exhibitor to continue to attract many horror fans and attract consumers who like dramas (the over-25 group) as well. Thus, the demand for Horror A depends on which other movie it is paired with.

Now consider a group of distributors who have to design contracts to offer the exhibitor. In a world with zero transactions costs and no regulations, each distributor would like to negotiate a contract with the exhibitor that specifies the exhibitor's entire slate of movies. That way, each distributor would be sure that the exhibitor would take into account all of the cross effects on the demand for its movies. Because such a contract is prohibited by the Paramount decrees and is likely prohibitively expensive to negotiate, monitor, and enforce in any case, distributors use instead an incentive contract of the type described above. This contract provides the exhibitor with the incentive to maximize the revenue from each of its movies. Since hits are rare and have high revenues, the exhibitor can be expected to show a

[12] It is interesting to note that in 1984 the U.S. Department of Justice gave studios permission to forward integrate into exhibition again (Mansfeild, 1997). Some distributors did so, including Sony, who bought the Loew's theatre chain. Block booking is still frowned upon, and the use of blind bidding varies by state. However, the lack of integration suggests that short-term contracts and long-term relationships allow the studios to accomplish many of the same goals that integration and long-term contracts accomplished in the studio era.

hit even if its share of the revenue is low. So in this case, the 90/10 split applies. Revenue is lower for movies later in their runs, so the exhibitor's share of the revenue must rise, and the 70/30 or 60/40 splits apply. Without the increased share the exhibitor would drop the old movie and show a new one instead.

Other contractual arrangements between distributors and exhibitors are also interesting. For example, the distributor receives no share of concession revenues. To those not in the industry, this may not seem important, but concession profits may account for half of an exhibitor's profit! Given this, the exhibitor may have a conflict of interest because he has to balance his own desires against the goals of his principal, the distributor. Exhibitors want to get as many people to come to the theater as possible and sell as much food and drinks as possible, but they typically get only a small percentage of the ticket revenue. As a result, exhibitors will be tempted to keep ticket prices quite low in order to encourage attendance. On the other hand, the distributor wants to maximize ticket revenue and does not care about concession sales, so the distributor prefers a higher ticket price.

To understand why concession sales are left out of the contract, it is important to think about the overall goal of the exhibition contract and then think about the optimal way to implement that goal (or at least come as close as possible to achieving it). Ideally, the distributor and exhibitor would like to maximize the sum of ticket sales plus concession sales and then divide the two in an appropriate way. This is the overall goal. While attempting to implement this goal, the two parties must economize on transactions costs.

One simple solution that distributors could use to align the exhibitor's pricing incentives with their own is to simply include ticket prices in the contract. Distributors could force exhibitors to charge a certain price for admission, and thereby provide incentives for exhibitors to keep prices up. Unfortunately, such a contract is known as a vertical restraint, and it frowned upon by the courts as an anti-competitive practice. Many economists believe that such practices should not be discouraged, in part because they allow contracting parties to economize on transactions costs (for a discussion, see Carleton and Perloff, 1994).

The concession sales create different incentives for distributors and exhibitors, so why not align their incentives by putting concession sales in the sharing contract? One explanation is that distributors would find it difficult to monitor concession sales and attribute the sales

to the various movies showing in the multiplex. Without monitoring, the best the contract could do is attribute the concession revenues to the various movies based on the number of tickets sold. This suggest that contracting on the number of tickets sold (rather than ticket revenues) could keep ticket prices up. The number of tickets sold is sometimes used in exhibition contracts, but does not appear to be common (De Vany and Eckert, 1991).

The most compelling explanation for how ticket prices are kept up has to do with the structure of long-term relationships. As mentioned above, distributors typically negotiate with exhibitors, and even when competitive bidding is used they are by no means required to accept the highest bid. If an exhibitor has delayed payment or been otherwise uncooperative in the past, the distributor can be expected to prefer the exhibitor's competitors. This "threat" encourages exhibitors to keep admission prices in a reasonable range from the point of view of the distributors.

Further, as long as the exhibitor's ticket price can be observed at the time of contracting, the parties can set their contract terms while taking the ticket price into account, and contract terms will vary across theaters with different ticket prices. Other things equal, low ticket prices should be associated with a higher flat payment from the exhibitor to the distributor and a higher distributor share of ticket revenues, so that the expected payment to the distributor ends up being the same as when ticket prices are high. Because the exhibitor can predict that the contract terms he is offered will depend on the price he charges (though not explicitly), the exhibitor may be provided with the incentive to set the ticket price in a way that maximizes the sum of total revenues. By giving all of the concession sales to the exhibitor, the contract ensures that the exhibitor has an incentive to maximize concession sales while economizing on the distributor's monitoring costs.

3.5. Compensating the Participants: the Net-Profits Controversy

In this subsection we will describe disputes surrounding the division of distributor rentals (the distributor's share of movie revenues) between the major studios and the talent they employ. Contracts in which prominent writers, actors, directors or producers receive a share of the revenue or a share of the profit in addition to an up-front payment have a long history

in Hollywood, but since the collapse of the HSS they have become increasingly common.[13] As sharing contracts have been more widely used, their complexity has increased as well. Many have argued that the contract terms are unfair. Much of the controversy has to do with the definition of "profit" used in the contracts.

The most common type of sharing contract in Hollywood is a net-profits contract, in which net profits is a *contractually defined term*, not profit as calculated according to Generally Accepted Accounting Principles (GAAP). Several disputes have arisen over the ex-post interpretation of the contracts, because on several extremely high-grossing movies the net profits were never positive. Litigation between individuals and studios has been frequent (Biederman et al. 1996), but often unsuccessful from the individuals' perspective. The first serious challenge to the net-profits contract was *Art Buchwald v. Paramount Pictures Corporation* (1990), a dispute over the net profits from the movie *Coming to America*, an extremely high-grossing movie. In the case, among other charges, plaintiff Alain Bernheim (a producer) charged that his net-profits contract was unconscionable, and that Paramount owed him a fiduciary duty. In the end, the court invalidated a number of provisions of Paramount's standard net-profits contract and awarded $900,000 (small compared to the request) to the plaintiffs, and the case was eventually settled (Biederman et al. 1996).[14] However, the court concluded that Paramount was not a fiduciary, except with respect to its duty to render an accounting.

In this section, we apply the same type of reasoning used above to explain that the net-profits contracts employed by the Hollywood studios are responses to the three key characteristics of the movie business. We provide some insight into why the court in *Buchwald*

[13] Talent at the technical end of the business - the lighting people, electricians, set constructionists, wardrobe assistants, etc. - is called *talent below the line* by those in the business (Resnick and Trost, 1996). This no doubt has to do with the placement of credits shown in the movie. They tend to be represented by their respective unions who watch out for their interests. It is the above the line folks - the creative people: the actors, directors, writers, etc. - who make the high salaries and receive sharing contracts.

[14] Despite this case, studios have not abandoned net-profits contracts, and in a more recent case, *Batfilm Productions v. Warner Brothers Incorporated* (1994), which disputed the net profits from *Batman*, the court sided with the studio. It seems likely that disputes over the definition of net profits will continue to occur.

Stars involved in television series have had similar complaints. Vogel (1998) describes how television star James Garner became involved in a dispute with Universal Studios over the popular television series *The Rockford Files* (1974-1980). Garner initially agreed to something similar to a net-profits deferred compensation contract and the studio later claimed that there were no profits to share. The case was reportedly settled out of court for $10 million.

v. Paramount was persuaded that many of the contract terms were the result of abuses of market power rather than adaptive responses to fundamental underlying conditions. In our description of the contracts and the reasons for their use, we rely heavily on a detailed analysis by Weinstein (1998). We describe the potential for the studio to experience a conflict of interest in its accounting role, and describe some factors that mitigate this potential conflict.

A considerable amount of the controversy and confusion is related to the definition of net profits. Because net profits is defined contractually, the definition can vary from contract to contract. Typically, however, net-profits contracts use a fairly standard formula for computing net profits. Garey (1992) and Weinstein (1998) provide useful descriptions. Start with a dollar of box office revenue (the gross). As noted above, the distributor (the studio) and the exhibitor typically use a sharing contract, so the distributor does not obtain the full dollar. Suppose that the movie is a hit, so the 90/10 split applies once the house nut has been subtracted. Suppose the house nut is 10 percent of the gross, so out of each dollar the distributor gets 90 percent of 90 cents, which is 81 cents. From the distributor's share, approximately 30 percent is deducted as a distribution fee, leaving 56 cents. The distribution fee pays for the distributor's distribution expenses and includes some profit for the distributor. Next, advertising and promotion expenses, including interest costs on advertising and prints, are deducted. These costs are typically 25 percent of the distributor's rentals (the 81 cents), so this leaves 36 cents. Then an overhead charge of 10 percent of advertising and promotion is deducted, leaving approximately 32 cents. From the 32 cents, "negative costs" (the costs of developing and producing the movie), plus interest on negative costs, are deducted. An overhead charge on negative costs is also deducted. >From what is left, any additional loans, plus interest, are deducted. If there are any gross participants, their share also gets deducted as a cost, and interest and overhead charges on the gross participation are also deducted.[15]

[15] In a gross participation contract, the payment is a function of the movie's gross (the revenues) instead of net profits. Only the most famous actors and directors receive such contracts, and "first-dollar" gross contracts (contracts that begin to pay as soon as the first dollar of revenue is earned) are the most favorable participation contracts in Hollywood. However, most gross contracts involve contingent payments, and this effectively blurs the distinction between a gross participation contract and a net-profits contract. The net-profits formula provided here shows that net profits is essentially a function of gross receipts; the only additional terms that affect the computation are production and distribution costs. Because most gross participation contracts involve contingent payments that are not made until these costs are covered, a typical net-profits contract can be transformed into a typical gross participation contract and vice versa (see

Anything left of the initial dollar is net profits. From net profits, the distributor (the studio) gets a share ranging from 50 percent to 80 percent, and the producer (if independent) gets the rest. The talent (writers, actors, and directors) is paid from the producer's share.

It is easy to see from the above description that the standard net-profits contract appears to be very one-sided and unfair. Even large grossing pictures, like Coming to America and Batman, often never generate positive net profits. As the movie continues its run, the gross goes up and up, but so do the distribution, print, and promotion costs, and interest is accumulating all the time. Interest and overhead must be paid off before the principal starts to be reduced. Cynics claim that only in rare cases in which low budget pictures that have hardly been advertised surprise everyone and gross $100 million or more are net-profits participants ever paid, and even then it only occurs because the studio's creative accountants cannot hide the money! Yet, it is clear that even when net profits are negative, the studio often still earns a profit according to GAAP. The studio's profit comes from the distribution fee, the advertising fee, the interest and overhead charges, and its share of net profits. Each "cost" component has some margin of profit calculated into it. The studio has a potential conflict of interest because it must be trusted to perform the accounting properly. It has an incentive to use creative accounting to increase its own profits. The threat of lawsuits, the likelihood of repeated dealings with the same talent, and the risk of adverse publicity imperfectly mitigate this conflict of interest.

Although several of the contract terms appear to be arbitrarily defined and weighted heavily in the studio's favor, Weinstein (1998) argues that net-profits contracts have a long history in Hollywood, and that because of this the modern contract terms are well-understood by Hollywood agents and lawyers. As a result, modern net-profits participants know what they are getting into when they sign a net-profits contract and take their expectations into account when negotiating the deal. Weinstein shows that sharing contracts, some of which had features similar to the modern net-profits contracts, were used as early as 1923. These early sharing contracts tended to be used more by the small studios than the large successful ones. This alone provides some insight into the reasons for their use - smaller studios were more subject to failure, and had a greater incentive to reduce up-front costs and share risk.

Weinstein, 1998, for further discussion).

As an early example of a net-profits contract and the rationale for their use, consider the net-profits contract used in 1950 when Universal was experiencing financial difficulties but wanted to hire Jimmy Stewart for the movie Winchester '73. Universal could not afford Stewart's normal salary of $250,000 per movie so it offered him a contract with no up-front payment but 50 percent of the "net profits." Net profits were defined in the contract as the gross in excess of twice the negative cost. The break-even point of twice the negative cost was chosen because it was calculated to be the point at which the studio would recover its distribution and advertising expenses as well as its production costs.

Although the contract between Universal and Jimmy Stewart lacked many of the features of the modern net-profits contract, the reason for its use is instructive. Knowing that movie-making involves substantial up-front costs that may not be recouped (because of uncertain demand), the studio reduces the possible downside by lowering the up-front payments to its talent. Doing so does not come without cost - any risk-averse economic agent who is forced to bear risk must be compensated with a higher expected payment - but the cost is worth bearing, because the studio only has to pay if the movie is a success, in which case there is enough money for everyone. Thus, the key characteristics of the industry - its high up-front costs and its tremendous uncertainty - explain why net-profits contracts were and continue to be used.

The other key characteristic of the movie business, the need for collaboration on a large scale, also may play some part in the use of modern net profits contracts. Movie production involves several opportunities for major stars to hold up production in a variety of ways. Stars can be difficult to work with, insist on special treatment in a variety of forms, and drive production costs up considerably. Chisholm (1997) argues that one of the things a net-profits contract accomplishes is that it aligns the incentives of the net-profit participants with the incentives of the studio. However, as Weinstein notes this was not the original reason such contracts began to be used, and even today it is questionable whether the contracts play much of a role in regulating behavior on the set. In modern Hollywood, news travels very fast, and an actor with a reputation as someone who is difficult to work with can expect to be shunned accordingly.[16] Further, since only a small fraction of net-profits contracts ever have

[16] As a qualification to this, note that it seems likely that not all of a participant's reputation may depend

positive net profits (perhaps 10 to 20 percent) it is unlikely that prominent actors can make marginal adjustments in their performance that have any substantial effect of the likelihood of earning positive net profits - most of the time their choices will be inframarginal. Thus, the main explanation for the use of such contracts is that they allow the studios to share risk - they only pay off in the event of an unanticipated success.

The use of net-profits contracts increased once the HSS began to collapse (Weinstein, 1998). With the introduction of television and the abandoning of B-movie production, the studios began to make fewer movies with larger budgets. This increased up-front costs per movie, and also made the business more risky. Further, once the HSS collapsed, few prominent actors had long-term contracts with the studios, so movie-by-movie contracts became the norm. Studios became less stable places. Weinstein reports that the average tenure in office for executives in charge of production at the most stable studios was around 20 years during the 1940s and declined to four years by the 1970s and 1980s. Turnover was even higher at weaker studios.[17] Weinstein argues that wealthy stars in the post-HSS era were often in a better position to absorb risk than the production executives they worked for; hence the increased use of sharing contracts.

In sum, the broad features of the modern net-profits contract have a long history in Hollywood, so it is reasonable to assume that all Hollywood agents and lawyers are familiar with what they imply. Several independent distributors exist, so there are substitutes for the studios. The reason why writers, producers, directors, and actors continue to work with the studios is that they provide development, production and distribution services all in one firm, and put the credibility of their names behind projects. These services allow the studios to compete with entrepreneurs' other production and distribution alternatives, and if participants willingly sign the studios' net profit contracts, then this suggests that the

on the bottom line. For example, a director may value respect from peers more than the bottom line, and may be willing to go over budget if it improves the artistic quality of the final product, whereas a studio may prefer to appeal to the masses and keep costs down, a point Putnam (1998) dwells on.

[17] It is not obvious that dismissals should be frequent in an environment in which no one is able to forecast at the financing stage. Filson, forthcoming, shows why rapid executive turnover can be an optimal response when firms operate in stochastic environments with hits and dogs. The basic explanation is that it is difficult to distinguish the effects of a poor project from the effects of managerial incompetence, so if an executive has a string of dogs, then even though optimizing decision-makers in the firm think there is a high probability that the projects were poor, they also believe that there is a high probability that the executive is incompetent.

overall benefits of working with studios offset the potential for dissonance.

However, even though the broad features of the net-profits contracts appear to have sound reasoning behind them, in Buchwald v. Paramount several of the features of the net profits contract were found to be unconscionable. Some of these features include charging a fixed, predetermined overhead on production costs and advertising expenses instead of computing the overhead charge by taking into account all of the movies produced in a given period, and charging overhead and interest on payments to gross participants.

Weinstein, nevertheless, offers plausible explanations for some of the practices that appear at first glance to be particularly unreasonable. For example, as noted above, one of the "costs" deducted when computing net profit is the cost of compensating the gross participants. Further, an overhead charge is attributed to this expense, even though compensating gross participants involves little more than writing a check. Weinstein's explanation is as follows: The studios need to be able to spread their overhead costs among a variety of movies, and must do so in a way that allows net-profits participants to audit their contracts without having access to the studio's cost data on every movie it makes. As a result, the studios charge a fixed percentage overhead charge. By itself, this may lead to an inefficient allocation of overhead, because efficiency requires that more expensive movies receive a larger overhead charge. Because movies with gross participants are likely to be expensive, charging overhead on the gross participation increases the overhead attributed to expensive movies, and brings the studio closer to an efficient allocation of overhead while still allowing the net-profits participants to audit their contracts.

One additional form of chiseling that is not easily dealt with is related to the fact that the costs included in the calculation of net profits are typically the studio's costs. Studios have often been accused of using creative accounting methods in order to transfer costs and benefits between projects in order to cheat the net-profit participants. One response of independent producers to the studio's ability to manipulate costs is to avoid studios as much as possible until the final product is ready to distribute. However, even once distribution starts, studios still have the ability to control a variety of costs. As noted above, studios have long-term, on-going relationships with exhibitors. Studios have been accused of negotiating deals with exhibitors in order to shift distributor revenue away from movies with considerable

net-profits participation and toward movies with little net-profits participation (Cones, 1997).

Further, even though agents are familiar with the standard contract terms, problems can arise if agents do not represent the talent effectively. Agents' private incentives are often incompatible with the interests of their clients. One potential conflict between agents and talent is developing as we write (Bates and Eller, 2000). Agents to date, by agreement with the Screen Actor's Guild (SAG), by California state law, and by old federal consent decrees, are not permitted to have financial interests in either television or movie productions or distributions. Agents would like to do this, however, and one can imagine that agencies might even become part of the large entertainment conglomerates. Clearly, if an agent is part of the studio then the actor may end up with no effective representation. Opponents to agents participating in production and distribution in the SAG are many, however, and very powerful (e.g., Warren Beatty). It is doubtful that Disney or Viacom soon will be teaming up with top agencies, since SAG seems much opposed, as is the Department of Justice.

Managers, whose functions are close to that of agents, are not, in fact, so restricted, but they generally represent only well-established talent, who are capable of hiring high-priced Hollywood lawyers to keep their managers honest.[18] However, stories of managers gone bad are common, and even the most famous stars fall victim now and again. Clearly, reputation effects, morality, and the law of fraud are not perfect prophylactics against studied malfeasance. A prominent recent example involved the comedian Garry Shandling and his former manager Brad Grey. Shandling accused Grey of exploiting his two positions as Shandling's manager and the executive producer of Shandling's popular Larry Sanders Show to obtain excess fees and also to create several new shows using talent that had been involved with Shandling's show. The case was eventually settled out of court.

[18]Managers provide a broad range of career-management services, many of which may also be provided by agents. The main distinction between agents and managers is the following: agents are primarily involved in seeking employment and the financial aspects of contract negotiations, while managers are primarily involved in the other aspects of managing the client's career (career development, financial management, public appearances, etc.). However, because both are involved in the business of advancing their client's career, there is not a precise distinction between the two functions, and courts sometimes have to use judgement to determine which is which. This is not to say that the distinction is unimportant; the consequences of being a manager who acts as an agent are quite serious. Biederman et al. (1996) describe several court cases.

3.6. The Casting Couch: If You Want to Get Ahead, You Have to Give a Little

The famous "casting couch" and the alleged sexual exploitation of young men and women entering the movie industry is well-known to the lay public. Biographies of those in the business are awash with these stories. Although little more than strings of anecdotes are available, all agree that it is a problem for newcomers who have not established themselves in the industry, but not for veterans. In this subsection, we argue that the big-project, big-budget, hit-driven nature of the business creates an environment that can lead to exchanges of sexual favors of newcomers.[19]

The exchange of sexual favors may lead to conflicts of interest if decision-makers end up choosing talent on the basis of sexual exchanges instead of merit. The reason why is that the decision-maker's principal, the studio, wants the best talent available. However, the potential for conflicts of interest is not as severe as it first appears. The nature of the business makes it difficult to judge "merit" in many cases. Above we linked uncertainty in the movie business to executives' difficulties in judging the quality of movie projects, but a second source of uncertainty comes from difficulties in judging the quality of unknown talent. Does a particular actor have the potential to be a "star," one of the few performers who can attract large crowds on opening night? On extremely rare occasions there may be new actors whose obvious talent allows them to stand out from the rest, but within broad categories most newcomers trying to make it in Hollywood are essentially indistinguishable from each other, and Goldman's Law described above applies to star-making as well as movie-making - it is extremely difficult to predict who will become a star and who will not.

This environment, in which executives are uncertain about the potential of newcomers and in which hits earn tremendously high revenues, naturally creates a "superstar" effect that has been described by Rosen (1981) and MacDonald (1988): The pool of newcomers attempting to enter the business will always be large, and the newcomers will willingly accept wages well below what they can earn in their best current alternative. Newcomers accept low wages because success in the movie business, though rare, is rewarded very highly, and the returns may be out of proportion to talent. The superstar effect means that small differences

[19] Dutka, 1991, Francke and Kasindorf, 1975, and McCreadie, 1990 describe the Hollywood casting couch.

in talent can lead to huge differences in pay.[20]

We argue that in fact, if their need for subsistence did not prevent it, most new actors and actresses would accept no wage at all and even pay for the opportunity to appear in a film.[21] Lacking money, many choose to "sell" their sexual services in an attempt to influence producers, who otherwise have few ways to distinguish one newcomer from another. According to this view, hanky-panky though common is not really coercive but represents quid pro quo exchanges.[22] Though the casting couch exchange is counter to state and federal law, it may be a crime without a victim.[23] As one lawyer who talked with us off the record said, "it's part of the wages on both sides of the exchange."[24]

Further, sexual exploitation is taken less seriously by those in this extremely sophisticated if not wholly cynical industry than one might expect. The industry is built in part on sex, so sexy talk off the set is common and a selling point in the gossip network which generates a great deal of valuable publicity. Exchanges of all sorts of favors are routine amongst those in this business, and quid pro quo sex may be one of the commodities. In any case complaints to the Equal Employment Opportunity Commission are rare, and suits under California law are as well.[25]

[20] The music business and professional sports also appear to exhibit superstar effects (Frank and Cook, 1996).

[21] In fact, payments of this type occur. The fraud division of the Los Angeles Police Department devotes considerable resources to chasing down persons promising, for upfront dollars, to find employment for new talent. However, mitigations in the form of cheap information are available. Newcomers can learn of what is "legit" from a plethora of extension courses, workshops, books, and information on the internet. Still, many learn the hard way.

[22] Of course, producers are not the only ones who have something to trade in return for sexual favors - writers may provide more lines (and thus more exposure) in return for sex, a director may agree to feature an actor in more scenes, etc. For an account of such practices, we refer the reader to the recent movie Bowfinger, a movie about making a movie. In Bowfinger the character played by Heather Graham advances her career by having sex with essentially everyone else involved in making the movie.

[23] Of course, even if neither of the parties to the exchange is a victim, sexual exchanges may have victims outside the exchange. For example, a newcomer who does not get an audition may be considered a "victim" if an audition is allocated to another in return for sex. Whether these externalities are internalized by the implicit contracts involving sexual exchanges is not clear.

[24] Note that this statement suggests another reason why the decision-maker's principals might tolerate decisions based on sexual exchanges: if the decision-maker receives sex on the job, then the sex becomes part of his compensation, and the principals can pay the decision-maker lower wages than they would have to otherwise.

[25] Interestingly, other than the odd case law decision - which is very rare since most complaints are settled out of court - little has been written about Hollywood sexual harrassment in the law or policy journals, nor is there a book or dissertation on the subject as far as we could determine.

Still, it is worth noting that UCLA, USC, and various other groups run extension courses and workshops on sexual harassment. This suggests that not all sexual advances involve voluntary exchange. Further, it is not at all clear that newcomers who attempt to use sex to get ahead in the business are all successful. It seems likely that a type of "prisoner's dilemma" exists here - individuals who attempt to use sexual favors to distinguish themselves from other newcomers likely find that many other newcomers are attempting to use such favors for the same purpose. The end result may be that trading sexual favors becomes necessary for entry into the business, but that it is difficult to distinguish oneself through such trading because so many are engaged in the same practice.

Although precise figures are not available, it seems likely to us that sexual exploitation has been reduced since the collapse of the HSS. Under the HSS studios had great power. Contracts were long-term and lucrative, and sexual demands were, it would appear from the "buzz" of the time and biographical materials today, part of the entry costs. It is said that one famous director had a sign on the ceiling above his couch in his Culver City studio office that read, "Don't forget, darling, tomorrow you're going to be a star" (Franke and Kasinor, 1975). With the breakup of the HSS and the death of the long-term contract, bargaining power of powerful people to make the careers of young actors has been considerably diminished.

4. Conclusion

"For all their grandiosity, for all their ability to infuriate, movie people are rarely stupid." John Gregory Dunne (1998), p. vi.

In the movie business, three key characteristics have influenced firms' choices of organizational forms and contracts. These choices have structured the disputes that have emerged between the studios on the one side and the anti-trust authorities, exhibitors, and talent on the other side. Our analysis suggests understanding the key characteristics that shape competitive behavior is important for adjudicating disputes, and we believe that this conclusion extends beyond the movie business: an in-depth industry study should be one of the first steps in any legal action involving industry participants in an industry with which the court is unfamiliar.

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