Creating the Image

A Transaction Cost Analysis of Joint Value Creation in the Motion Picture Industry

by

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Abstract

This dissertation is concerned with expanding the scope of transaction cost theory from its primary concern with governance alignment to also encompass transaction value. The aim is to provide strategic management guidance, not only on how transactors best can structure their transactions, but also on how they can maximize the joint value created through these transactions.

Value creation is implicitly embedded in the governance alignment literature in that efficient governance contributes to creating value by reducing transaction costs. But this literature does not account for the value creation effects of transaction-specific investments even though these investments are made for this very purpose. To resolve this shortcoming, a transaction value model is proposed that incorporates both sets of effects.

The proposed model rests on the relationship between transaction-specific investments and transaction governance structure. Within the transaction cost literature, the effects of specific investments on governance structure is one of the most important, tested and confirmed tenets. However, the origins of specific investments are less explored. Yet, understanding the origins of these investments is strategically important, as they may contribute significantly more towards joint value maximization among the transactors than investments into general purpose assets. Hence, this study turns the possibly most central TCE tenet upside-down and asks: How does the choice of governance structure affect the transaction parties’ specific investments?

To explore this question, I have carried out a microanalytic study of transactions between theatrical feature film producers and distributors in the North American motion picture industry. These transactions require substantial specific investments into both production and distribution, and they are governed by a variety of contracting forms spread across the market-hierarchy continuum. As such they offer a rich empirical setting for exploring the effects of contracting on specific investments.

The study finds that contracting does affect specific investments in the production-distribution transactions. Patterns emerged from the data that showed, first, that more integrated types of contracting reduce certain kinds of uncertainty that encourage specific investments by lowering the
associated risk. Second, certain specific investments have inherent coordination requirements that are only satisfied by more integrated contracting. Third, the relationship between structure and specific investments may be better understood in terms of interdependence, which is a product of specific investment requirements and affects contracting. Finally, the data suggests that in the presence of positive spillovers, integrated contracting induces specific investments by internalizing these effects, thereby creating greater economies of scale and scope for a transactor’s investments.

These findings support the proposed transaction value model, which provides a basis and framework for further transaction value research.
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1 Introduction

Transaction cost theory’s core variables make up some of the most central parameters for understanding value creation in the motion picture industry. The importance of transaction-specific investments, uncertainty and contracting in this regard is well recognized by industry practitioners, not as theoretical constructs but in their practical applications. However, in terms of explaining value creation, transaction cost theory remains underdeveloped and our scholarly understanding of the impact these variables have on value creation is thus limited and fragmented.

For the motion picture industry’s practitioners, understanding the conditions under which investments are made into the production of particular movies is essential since these investments represent the very basis for their value creation. The assets created from investments made into any particular movie project, such as the script, production design, recorded picture and sound material and the edited final cut, cannot be redeployed to another project without a total or significant loss of productive value; therefore they represent an archetypical example of asset specificity, upon which transaction cost economics (TCE) (Klein, Crawford, & Alchian, 1978; Williamson, 1975, 1985) bases so much of its explanatory power. Production investments are hence largely transaction specific, and industry value creation is dependent on these specific investments.

The importance of production investments for value creation is recognized by scholars in the field of media economics. They have for instance identified investments into a particular movie as a key variable for determining commercial performance in domestic and international markets. Through mechanisms triggered by the substantial scale economies present in the motion picture industry, this relationship between investments and performance has substantially contributed in explaining the dominant position of American products in the international markets for audiovisual products (Jayakar & Waterman, 2000; Lee & Waterman, 2007; Waterman, 1988, 1993; Wildman & Siwek, 1988).

Less recognized, also by media economy scholars (Hadida, 2009), are the investments made into the marketing of a particular movie. These do create specific assets in much the same way as production investments. For
instance, an advertising campaign created for one movie cannot be redeployed to another without a total or significant loss of productive value. These assets also contribute to value creation in a similar way to those created in the production of a movie, and as discussed in more detail in Section 1.2 below, it is the sum of these investments that affects the ultimate value of a movie and hence also the return on both sets of investments.

Production investments are typically the responsibility of a movie’s producer, while marketing investments fall under its distributor. Hence, the governance structure applied to the transaction between the production and distribution functions is also central to our understanding of the ultimate value creation because it represents an important part of the context within which each type of investment is made. The possibly most central tenant of TCE theory is its probabilistic predictions of the discriminating alignment of transaction governance structure with asset specificity (Williamson, 1991). Governance structures range from the market in one end via various contractual and/or equity-based hybrids to the hierarchy of internal organization (the firm) in the other. The specter of governance structures deployed for seemingly similar transactions between the production and distribution functions in the motion picture industry is wider and contains richer variances than one may expect. It spans from fully integrated structures in which production and distribution, with their corresponding investments, take place within one single company to almost pure market transactions, where a distributor purchases a movie financed and completed by an individual production company to promote and sell through its own channels (Cones, 1997). There is thus a great deal of variation in the structural context in which the transaction-specific motion picture investments are carried out.

For practitioners, the importance of understanding the conditions for investments to be made into single movie projects is closely linked to a third TCE variable: The high level of uncertainty that characterizes the motion picture industry. Research carried out by DeVany and Walls (1996, 1999) has largely confirmed the industry proverb that “nobody knows anything”, a phrase first coined by screenwriter and novelist William Goldman (1984), which refers to the belief that prior to a movie’s release nobody in the industry has any real idea how well it will do. DeVany and Walls discovered that revenues from individual movies are asymptotically Pareto-distributed and have infinite variance. Revenues diverge over all scales, and revenue
forecasts have zero precision. Under these conditions, the capital markets will not function as they normally do. Generally speaking, the more profitable projects attract capital to better conditions and the projects promising better returns are therefore realized while others are not, but when revenue forecasts are grossly unreliable it becomes accordingly difficult to distinguish profitable from unprofitable projects at the time an investment decision has to be made.

Given the industry’s reliance on transaction-specific investments for value creation, the high level of uncertainty combined with specificity, and the significant variance in governance structures applied to the production-distribution transactions, any guidance the theory can provide a better understanding of how these variables affect investment conditions, and thus value creation, should be welcomed as an important strategic management tool.

1.1 A TCE Perspective: Preliminary Considerations

As briefly illustrated above specific investments, contracting and uncertainty are key variables to our understanding of value creation in the motion picture industry, and since the relationship between the first two represents the possibly most important tenant of TCE theory the TCE literature also becomes on obvious place to look for guidance. However, while a vast empirical TCE literature generally supports the predictions the theory makes of governance structure based on the level of asset specificity present in a transaction (David & Han, 2004; Macher & Richman, 2008; Rindfleisch & Heide, 1997), the understanding of the reverse relationship and the origins of specific investments in general is underdeveloped. Several calls have been made for an endogenous treatment of specific investments (Bensaou & Anderson, 1999; Kang, Mahoney, & Tan, 2009; Macher & Richman, 2008), but as of yet the literature offers only very limited guidance on structural conditions for specific investments.

Understanding the conditions for investments into specific assets is important because these assets generally improve productivity and generate more value compared with nonspecific assets (Bensaou & Anderson, 1999; Williamson, 1985). Contextualized in the motion picture industry, in which every movie project resembles an R&D project with overwhelmingly specific assets, the benefit of better understanding what conditions may
induce investments into such assets is apparent, but it applies to all industries. The lack of endogenous treatment in the TCE literature is therefore a shortcoming that becomes particularly evident seen from a value creation perspective. Given the established correlation between the two key TCE constructs, an endogenous treatment of specific investments should start with developing a better understanding of how contracting affects these investments.

The third variable discussed above, uncertainty, is considered a key feature of the transaction cost argument (Coase, 1937) and defined as one of the key dimensions of a transaction (Williamson, 1975, 1985). Yet, it is mostly considered as explaining governance structure, and the theory’s uncertainty-related predictions have not received the same level of empirical support as those based on asset specificity (David & Han, 2004). To further develop our understanding of the uncertainty construct and its impact on other TCE constructs is thus desirable, and given the level of uncertainty present in the motion picture industry, it offers a rich empirical environment for pursuing this objective.

### 1.2 Value Creation in the Motion Picture Industry

Understanding the motion picture industry’s dependence on transaction specific investments and how the production-distribution transaction joins the two main categories of such investments are central to the arguments being made here.

That producing a new movie generates value is obvious even to most casual observers: Cast and crew are assembled by a producer to record the performance of an ideally intriguing story under the creative leadership of a director. The output of all these creative and “humdrum” inputs is a recorded media product that may be sold in several media markets, including theatrical, home video and television, around the world or only in selected local media markets. Today, producing theatrical feature films for a broad international audience is a major enterprise requiring substantial investments. Statistical data that was published annually up until 2008 from the Motion Picture Association of America (MPAA), an interest group for the major American studios, shows that the average production cost of a theatrical feature film produced by their members was USD 70.8 million in 2007 (MPAA, 2008). Bigger recent event movies like The Dark Knight
Rises and John Carter have production budgets of approximately USD250 million (IMDbPro, 2012a, c). While production costs or investments give an indication of the value created, such measures may not necessarily equal the value. A movie’s value is ultimately dependent on its earnings in the marketplace, and this is not only dependent on the investments made into the movie, measured in its costs, but also on numerous other factors such as the quality of the performances, the movie’s technical quality, the cleverness of its story or concept, and so forth. The two measures for estimating value – production costs/investments and estimated revenues – are also reflected in the United States accounting standards for the movie industry, in which the value of film assets is determined either by capitalized costs or by estimated ultimate revenues (Levine & Siegel, 2001). However, other things being equal, higher production spending or costs for a movie increases its value, and since production cost seems to be the best available measure until a movie has been through its exploitation cycle when the ultimate revenues are determined, not only estimated, it has also been used extensively as an operational variable for measuring the sector’s value creation in media economic studies (Wildman & Siwek, 1988, 1993).

What seems to be less recognized, despite the increasing attention paid to the subject in the industry trade press, is the value creation that takes place in connection with the marketing of a movie. The average marketing costs for an MPAA-member theatrical feature film was USD 35.9 million in 2007 (MPAA, 2008), representing 34% of the average movie’s total production and marketing costs. The fact that the average marketing investments represents one-third of the total production and marketing investments, and that the marketing costs of a movie in some cases grossly exceed its production costs (Grove, 1999), signals that industry practitioners indeed see marketing as a crucial ingredient to the total value creation in the motion picture industry.

When a new movie is released theatrically, its share of the cinemagoing audience, and therefore its commercial success will depend on its performance in the short-run competition with the other movies in the marketplace at the time. For the distributor releasing the movie, the problem is to convey to potential viewers credible information on the type and character of the movie and the quality level they may expect from it (Caves, 2000). This is particularly important since there is no price competition between movies in the consumer market (Vogel, 2010). Through advertising
campaigns and investments in other forms of promotion, the distributor may communicate specific characteristics of the movie and create an expectation of a certain level of quality (true or false) to potential cinemagoers, and thereby attract a larger market share and higher revenues. Marketing investments into a specific movie may function as an indicator of that movie’s value, in the same manner as production investments are seen as such an indicator. This view is also supported by the United States accounting standards for the industry in which capitalized marketing costs also contribute to film assets (Levine & Siegel, 2001).

Studying the joint value created through production and marketing requires a joint product view on the production and distribution sectors’ respective contributions, which coincides the governance value analysis approach of TCE (Ghosh & John, 1999). Table 1.1 below shows outputs associated with the production and distribution sectors of the motion picture industry. The product columns specify both the output of the particular sector and the cumulative output produced up to each stage. For the first stage, the production sector, where the first copy of the actual movie is assembled – combining cast, crew, direction, music and so forth before recording and editing the performance – the product is the film itself or the first copy movie materialized in the film negative (or digital equivalent) and the bundle of contracts that follows it. The distribution sector adds marketing and circulation by licensing copies of the movie to different media in the exhibition sector. The cumulative product of the movie itself and these distribution efforts may best be described as the movie’s image, as this term is used by Boorstin (1961). A movie’s image is the audience’s pre-consumption perception of the movie, which determines its attractiveness. The image includes certain perceptions about both the movie’s characteristics and its quality.

<table>
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<td>Production</td>
<td>Film Negative (first copy)</td>
<td>Film Negative (first copy)</td>
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<tr>
<td>Distribution</td>
<td>Awareness / Circulation</td>
<td>The Movie’s Image</td>
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Table 1.1 - Product and cumulative product by sector

Following from this joint product view in which the movie’s image represents the joint product, the joint value (JVA) created in the production-
distribution transaction will be a function of the transaction parties’ total specific investments in the movie’s production ($I_P$) and marketing ($I_D$), as well as other factors.

\[
(1.1) \text{JVA} = f(\Sigma I_P; \Sigma I_D; \text{other factors})
\]

Other factors being equal, joint value increases with larger production investments, and joint value also increases with larger distribution (marketing) investments.

### 1.3 Theory Development and Contributions

TCE has become a dominant paradigm for studying vertical relationships, and with its more recent first extensions into governance or transaction value analysis (Ghosh & John, 1999, 2005; Zajac & Olsen, 1993), it offers a promising analytical framework for studying joint value creation and governance structures applied in cooperative joint product relationships. However, the value creation perspective is underdeveloped, still unable to provide any clear guidance on issues as those discussed above. Hence, the overall objective of this study is to further develop TCE in a transaction value direction.

It will be shown in Chapter 3 below that important transaction value shortcomings in the theory mainly rest on its almost exclusively exogenous treatment of specific investments. While the transaction cost literature has firmly established explanations and evidence for how transaction-specific investments affect governance structure, the reverse causal relationship of how structure affects investments has received only very limited attention. However, the correlation between certain types of governance structures and certain levels of specific investments is uncovered by the empirical testing of the TCE asset specificity–structure predictions (David & Han, 2004; Geyskens, Steenkamp, & Kumar, 2006; Macher & Richman, 2008; Rindfleisch & Heide, 1997), so the express aim of this study is to better understand the causality of the reverse directional dimension of this relationship: How and why does structure affect specific investments?

The answer to this question will offer a key to opening up for broader transaction value analysis, and it will unlock TCE’s greater potential as a strategic management tool to also be used for guidance in value creation and accumulation matters.
1.4 Dissertation Outline

Chapter 2 provides an overview over TCE theory as well as relevant media economic research that informs our understanding of the empirical context in which this study is made. Chapter 3 discusses in more detail the TCE-based conceptual framework of this study and focuses on the development of a conceptual transaction value model and the theoretical implications of an endogenous treatment of specific investments. In Chapter 4, a study outline of the qualitative case-study approach is provided, together with discussions of the methodological choices made for the study. Chapter 5 provides an empirical bottom-up analysis of the transactions involved in the motion picture industry value chain, with the aim of building a thorough understanding of production and distribution transactions and the dimensions of the production-distribution transaction. Chapter 6 provides primarily within-case analyses of the various contracting forms utilized between producers and distributors, including discussions of the transactors’ value creation and claiming within each. In Chapter 7, the empirically grounded patterns that emerge between contracting and specific investments are described and discussed. Chapter 8 discusses the theoretical implications of the findings presented in the previous chapters to achieve a better understanding of the impact of contracting on specific investments. Finally, Chapter 9 discusses the implications of the findings on the proposed transaction value model, as well as the methodological, policy and managerial implications of the findings, and it also provides suggestions for further research.
2 Media Economics and Transaction Cost Economics

This study is covering phenomena that have previously been studied by media economic scholars, albeit from different perspectives and with other objectives, and there are valuable inputs to be found in their studies. So while my research objectives are clearly defined by and within the TCE framework, the media economic literature offers a broad and empirically driven informative approach to understanding the specific context in which the study is made: The motion picture industry. Hence, this literature review chapter starts with a brief overview of relevant media economic literature before providing the same for the transaction cost literature. A deeper probing of the particular areas of the TCE literature leading towards my research objective follows in the next chapter.

2.1 Media Economics: An Overview

This section starts with a broad view of media economic research and its origins and traditions before narrowing in on the relevant research specifically carried out on the motion picture industry. Finally, it also reviews media economic research drawing on various branches of New Institutional Economics (to which TCE belongs).

2.1.1 Origins and Research Traditions

The academic field of research known as media economics is empirically driven, multi-disciplinary and very much an applied science. As its name indicates, it is closely related to both communications and media studies on the one hand, and to economics and business administration disciplines on the other. Various media economic scholars have contributed to defining the field of media economics: According to Picard (1989), media economics “is concerned with how media operators meet the informational and entertainment wants and needs of audiences, advertisers and society with available resources.” According to Alexander et al. (1998), media economics refers to “the business operations and financial activities of firms producing and selling output into the various media industries,” while Doyle (2002) defines it as being “concerned with the changing economic forces that direct and constrain the choices of managers, practitioners and other decision-makers across the media.” Albarran (2002) defines media economics as “the study of how media industries use scarce resources to produce content that is
distributed among consumers in a society to satisfy various wants and needs,” and he defines the media economy as, “the study of how media firms and industries function across different levels of activity (e.g. global, national, household, and individual) in tandem with other forces (e.g. globalization, regulation, technology, and social aspects) through the use of theories, concepts and the principles drawn from macroeconomic and microeconomic perspectives” (Albarran, 2010).

Media economics is empirically driven in that its focus on the media industries determines the boundaries of empirical research. Unless the research is somehow related to the media industries, it is not media economics. In studying the economic and business aspects of the media industries, media economics may draw on the full range of economics and business administration theories and methods, including associated disciplines such as psychology (e.g. in relation to consumer behavior issues) and sociology (e.g. in relation to management issues).

Still, one may argue that media economics is different from and more than straightforward economics and business administration studies with an empirical focus on the media industries. This is because it attempts to consistently implement in its analysis specific economic characteristics that are typically found in media products and services, as well as some quite specific traits of the media industries. Non-rival products, high first copy costs and low marginal distribution costs are typical product characteristics for media products, while industry traits include such issues as operating in both economic/business and cultural spheres, serving dual markets (media consumers and advertisers), etc. Implications are manifold but include, e.g. that much of the media economic studies and research have to implement significant scale economies and natural monopolies into its analysis. This is paramount for understanding international trade with recorded media products (Hoskins, Mirus, & Rozeboom, 1988; Waterman, 1993; Wildman & Siwek, 1988) and the nature of local cable or newspaper markets (Owen & Wildman, 1992; Picard & Brody, 1997). Another implication is that strong regulatory interests often have to be taken into consideration since the industries operate within the cultural sphere. Free market mechanisms and logic may therefore not work for media industries, even in countries where the institutional environment is typical for a market economy. For instance, governments may try to regulate the ownership of newspapers to secure diversity in published opinions and channels available for the public, as is
seen in Norway (Høyer, 1999). Yet another implication is that the special dynamics of serving dual markets, as experienced by advertising-supported newspapers, radio and television and much of the new media, have to be taken into consideration (see e.g. Albarran (2010), Helgesen and Gaustad (2002), Owen and Wildman (1992)).

This does not mean that media economics follows different kinds of logic than suggested by the general economic and business administration theories or that these theories are not valid for the media industries. Instead, media economic studies share common sets of assumptions for which the analyses drawing on these general theories have to be adjusted. From an economics and business studies perspective, it is these common sets of assumptions that are tied to and follows from its empirical focus, which sets media economics apart as a separate field. And for much of the media economics research it is indeed an objective in itself to uncover and define these assumptions or special conditions so that the analyses built on general economic or business administration theories can be adjusted to better fit the media industries.

While media economics shares its theoretical and methodological toolbox with economics and business studies, the relationship between media economics and media studies is a shared empirical basis - both fields focus on studies of the media. Media economics is more narrowly focused than media studies since its focus is on economic and business aspects of the media only, so it may therefore be seen as a sub-field of media studies (Helgesen & Gaustad, 2002). In itself, media studies is a relatively fragmented academic field, but its roots can be traced back to two main sources: Mass Communication Studies and Interpersonal Communication Studies (Rice, Borgman, & Reeves, 1988). Typical topics in the mass communication studies tradition are the mass media’s influence on democracy and its place in society. Studies where the individual – often the media end-user – is at the center typically come out of the other main tradition. One example would be a study of how children draw on media content in their interaction between each other.

Economic studies of the media can be traced as far back as to the mid 19th century. Among the first published studies was a predominantly economic study of journalism and the publishing business in the first half of the 19th century (Estreicher, 1867). Mosco (1999) argues that beyond single cases like this one, one can trace research traditions, which – at least with some
goodwill – may be placed within the field of media economics all the way back to Karl Marx, and he includes critical communication sociology as an example. However, if one shall consider media economics as an academic field as it is outlined above, the time horizon significantly shortens. In this form, media economics took form in the 1980s when the *Journal of Media Economics* was also established as the first international peer reviewed scholarly journal solely covering media economic topics. It first came out in 1987, before this media economic research was scattered over numerous media studies, economic and business studies journals.

Due to its specific empirical focus on the media industries, one also finds branches within media economics related to specific media. One branch is studying the economics of newspapers, one is studying television markets and one is focusing on the motion picture industry. As the media may converge and interact, so do of course these research branches. Online newspapers integrate the newspaper research branch with the new media branch and the motion picture industry and television branches naturally overlap, as one industry is a major content provider for the other.

**2.1.2 Media Economic Research on the Motion Picture Industry**

Since this study is particularly concerned with transaction value and the relationship between contracting and investments in the motion picture industry, the focus here is on studies aiming to explain the market performance of motion pictures. And that is because the findings from these studies help explain why the level of investments into particular motion pictures is an absolutely central variable in understanding the motion picture industry and its markets.

*Investments and Performance*

The significant, sometimes overwhelming presence of movies produced by American companies in many countries around the world has been the origin for complaints and criticism by cultural policymakers in the “importing” countries, which have made attempts to limit American imports through quotas, currency controls or other trade barriers (Jayakar & Waterman, 2000; Lee & Waterman, 2007). This issue has also triggered significant media economic research on trade in recorded media products, with most of this research based on three related and quite similar assumptions: a) economies of scale in distribution; b) cultural discount (which means that all other things being equal, audiences are assumed to prefer movies that are
produced in their own native languages or which reflect their cultural values; and c) that movies in which greater production resources have been invested (i.e. movies with bigger production budgets) will be more attractive to consumers (Hoskins et al., 1988; Waterman, 1988; Wildman & Siwek, 1988).

The theoretical framework established in these three assumptions may be referred to as the Domestic Opportunity Advantage (DOA) model since the size of the domestic market is a key explanatory factor. The model shows that due to economies of scale in movie distribution, producers in larger home markets enjoy greater marginal productivity from extra investments in their movies than producers within smaller home markets. Thus, American producers, with their large and rich home markets, produce higher budget movies than their foreign competitors, and due to their higher budgets the American movies are preferred in the international export markets. Figure 2.1 illustrates causal links in the DOA model. Empirical research based on this DOA model does support its logic, including the three basic assumptions of scale economies, cultural discount and attractiveness being linked to budget (Dupagne & Waterman, 1998; Jayakar & Waterman, 2000; Waterman, 1993).

![Figure 2.1 - The DOA model](image)

The DOA model assumption linking budget and thus investments with the attractiveness of the product is of particular importance to this study, and will be discussed further in Section 7.4 below.

**Other Research on Performance**

Among media scholars there were initially two other distinct research approaches attempting to shed light on the underlying factors determining the performance of motion pictures: The psychological approach that focused on the consumer, and thus on factors outside the direct control of the industry, and the economic approach, which focused primarily on supply-side factors.
The psychological approach has focused on individual moviegoer’s decision to: 1) attend movies among a vast array of entertainment options, and 2) to select particular movies. The psychological approach includes work within the uses and gratification paradigm, which assumes that audiences are active, that media use is goal directed, that media use fulfills a wide range of gratifications, and that the gratifications reported can be due to media content, the practice of exposure in and of itself, or the social situation in which the media-audience interaction takes place (Knapp & Sherman, 1986; Palmgreen & Lawrence, 1991) and research that combines the uses and gratification approach with a diffusion of innovations model (Austin, 1986, 1989). The independent variables tested in this psychological approach are demand-side oriented and related to audience members’ motivation, and contains mostly non-economic factors such as seeking entertainment, social utility, mood enhancement, etc. Among the few economic variables tested under the psychological approach is the price for theater attendance, which, not surprisingly, is found to be a significant negative predictor for movie attendance.

This psychological approach has later been expanded to include a broader set of individual spectator traits, and it has been joined by another approach that also focuses on factors outside the industry’s direct control, namely third-party information sources (Hadida, 2009). Studies based on this latter approach investigate the impact of non-experts (word-of-mouth), experts (professional critics and reviews) and peer-based sources (nominations and awards).

On the other hand, an economic approach has investigated the economic factors typically more within the industry’s control that influence collective movie attendance decisions, and paid special attention to supply-side variables. While the psychological approach tries to “explain” movie attendance, the economic approach attempts to uncover the ingredients of movie success and ultimately predict movie performance in the future (Litman & Ahn, 1998). One of the key independent variables that has been tested by researchers following the economic approach is the movie’s production budget. A number of major empirical studies have found significant positive effect of this independent variable on the dependent variable of movie performance (Basuroy, Chatterjee, & Ravid, 2003; Chang & Ki, 2005; De Vany & Walls, 1999; Hsu, 2006; Litman, 1983; Litman & Kohl, 1989; Liu, 2006; Miller & Shamsie, 2001; Pokorny & Sedgwick,
Among the distribution-related variables tested for which one can find significant effects are “P&A,” “release by major,” “number of screens” and “advertising intensity” (Ainslie, Dreze, & Zufryden, 2005; Basu, Desai, & Talukdar, 2006; Elberse & Eliashberg, 2003; Eliashberg, Jonker, Sawhney, & Wierenga, 2000; Hennig-Thurau, Houston, & Walsh, 2006; Lehmann & Weinberg, 2000; Litman & Ahn, 1998). These distribution-related variables are interesting to this study because they all indicate the investment level into a specific movie by the distributor. “P&A” is the abbreviation for prints and advertising, and refers to the amount of resources spent on the marketing and distribution of a movie. “Release by major” refers to a movie being released by one of the large North-American distribution companies (Buena Vista/Disney, Warner Brothers, Sony (Columbia/TriStar), Universal, Paramount, Twentieth Century Fox, and in some cases also Lionsgate and MGM/UA), which on average put significantly larger resources behind the release of a movie than the smaller “independent” distribution companies. “Release by major” thus indicates high distribution investments. “Number of screens” refers to the number of cinema screens for which a movie has been released. Releasing a movie “wide” on a high number of screens requires higher distribution investments (for more advertising, including expensive national television spots, more film copies, etc.) than a more “narrow” release on fewer screens. A high number of screens therefore indicate high distribution investments. “Advertising intensity” refers to the amount of paid advertising used to support the release of a movie, and hence also indicates the level of distribution investments.

In general, this economic approach to studying the financial performance of motion pictures finds that higher investments, whether in production or distribution, result in better performance. Furthermore, recent research also indicates that financial resources or investments serve as a catalyst to other factors for which studies have found significant positive effects on performance such as lead actors’ and the director’s star power (Hadida, 2010). Note that performance generally refers to gross revenues and not profitability, and that this research is thus of little guidance in the question of optimal investment levels. In fact, one major study found that while the budget had a positive effect on performance, it had a negative effect for return on investment (Ravid, 1999). However, the studies do confirm the
2.1.3 New Institutional Economics Applied in Media Economics

While the use of neoclassical economics within the Structure-Conduct-Performance (SCP) paradigm of industrial organization theory has been the dominant approach and much of the media economic research falls within this paradigm, other approaches can also be found in the media economic literature. Theories and research based on TCE and other theories within the New Institutional Economics paradigm, which are reviewed in the next section, are most relevant to this study.

Caves (2000, 2003) draws on contract theory to analyze and explain the organization of media industries such as the motion picture industry, the music industry and the book publishing industry. His contract theory approach focuses on the efficiency of contracting and incentive alignments between the contracting parties. With this approach, he is contributing to filling a gap left by the industrial organization approach: Caves’ contract theory approach seeks to explain the industry structures, which is a variable generally treated as a given in the dominant industrial organization studies.

An economic property rights approach has been central to studies focusing on the production of media products (Koboldt, 1995; Landes, 2002; Merges, 1995; Taylor & Towe, 1998; Towe, 2001, 2007). Here, the basic emphasis is that ownership matters and that efficient outcomes depend on the rights of ownership being placed with those who can utilize those rights most productively. Due to the intangible nature of media products, much of this literature focuses on economic copyright research. For example, Towe’s research does include analyses of how different copyright regimes may affect incentives and awards to artists, while Merges’ work emphasizes how legislators can create state-sponsored incentives for product creation through intellectual property rights. Due to its product and production focus, this economic property rights literature is most prominent around the somewhat blurred line between media economics and cultural economics. Media economists focus on media products, while cultural economists focus on cultural products that are not necessarily media content products.

Agency theory has been used to explain variability in media content across different media organizations (Napoli, 1997). Napoli uses agency theory to
identify organizational and structural independent variables such as implicit control mechanisms, organizational size and ownership type, and analyzes how these affect media content. It may be argued that this principal-agent approach shares the dominant industrial organization approach’s focus on how structure influences conduct, but it does represent a variation to the dominant approaches by drawing on theory outside the neoclassical paradigm. Agency theory has also been used to analyze the efficiency of markets for private film financiers (Bagella & Becchetti, 1995). Here, the authors investigate typical principal-agency problems, including the adverse selection and monitoring costs in the specific setting of a comparative study of film financing markets in the US, France and Italy, concluding that the first is more efficient that the latter two markets due to a greater market thickening and risk spreading.

Examples of transaction cost analyses of the media industries are still very rare. It has however been used to explain why the contracting between movie actors and the major studios changed from long-term contracting in the Age of the Studio (1929-1948) to market contracting in the most recent era (Chisholm, 1993). The use of long-term contracts – in some cases lasting seven years – in the Age of the Studio is explained by the high degree of asset specificity, or relationship-specific investments, between the actors and the studio and the high transaction frequency implied by serial movie production. During the Age of the Studio era the studios invested heavily in building stars who were also type cast or character-specific for a series of movies. Long-term contracts guaranteed that the studios, which were then vertically integrated, controlled all stages from production to exhibition, as well as the stream of income from the repeat appearances of the star/character. The actor or actress had an incentive to sign long-term contracts to stay with the studio since he or she would gain from the publicity received in the current employment relationship by the enhancement of future employment opportunities. With the breakup of the studios’ vertical integration into exhibition through the US Supreme Court’s Paramount decision in 1948, the studios’ ability to exhibit all movies within a “series” diminished, and the trend away from serial movie production decreased the degree of specific investments associated with a given agreement between an actor and a producer. Underlining the importance of specific investments associated with serial production for the contracting form, Chisholm also points out in her analysis that within the television
industry, which is still today involved extensively in the production of serial television shows, the dominant form of the employment relationship between actors and producers is still long-term contracts.

2.2 Transaction Cost Economics: An Overview

This section will first discuss the origins of transaction cost economics (TCE) in the context of New Institutional Economics, and then provide a brief overview of the theory and its applications. A more detailed discussion of the specific facets of particular relevance to this study follows in the next chapter.

2.2.1 TCE Origins and Context

Transaction cost economics is part of the New Institutional Economics research tradition. New Institutional Economics, which gained momentum in the late 1960s and 70s (Alchian & Demsetz, 1972; Arrow, 1969; Davis & North, 1971; Demsetz, 1967; Klein et al., 1978; Williamson, 1971, 1975, 1976, 1979), is different from the earlier institutional economics of the 1930s, including the works of Ronald Coase (1937) and John R. Commons (1934), in that it not only challenges the neoclassical paradigm, but also proposes a positive research agenda (Williamson, 1998a). Unlike mainstream neoclassical economics, which tend to treat the modern corporation as a “black box” or production function, the different branches of institutional economics, including transaction cost economics, primarily see the firm as a governance structure. While neoclassical economics studies the behavior of the profit-maximizing firm in the market, institutional economics is typically more concerned with the changing character of economic organization or governance.

The neoclassical literature has indeed considerably advanced our understanding of the market and market mechanisms. Within the neoclassical paradigm the market is, as Friedrich Hayek (1945) puts it, a “marvel.” Nevertheless, from a neoclassical viewpoint, transactions organized in non-market or quasi-market modes are regarded as examples of “market failure” (Arrow, 1969). By contrast, institutional economics takes the view of Ronald Coase. In his classic 1937 paper on “The Nature of the Firm,” he describes firms and markets as alternative means for doing the very same thing (Coase, 1937). In this tradition, new institutional economics seeks to explain “market failure” behavior by studying it from a perspective
of economic actors choosing alternative forms of economic organization for the market.

Within New Institutional Economics, one may distinguish between those approaches in which incentive alignments are emphasized and those which feature economies of transaction costs (Williamson, 1985). The incentive branch includes the property rights approach and agency theory, of which the first primarily operates on an institutional level that provides the rules of the game within which economic activity is organized, whereas the latter operates on a lower resource allocation and employment level primarily concerned with marginal analysis (Williamson, 1998b, 2000). The property rights literature (Demsetz, 1967; Furubotn & Pejovich, 1974; Grossman & Hart, 1986; Hart & Moore, 1990; North, 1984, 1991) emphasizes that ownership matters, and argues that new forms of property rights and complex contracting are efforts to overcome the incentive deficiencies of simpler property rights and contracting traditions. Discrete market contracting is replaced by more complex forms of contracting because that is the way residual rights to control can be placed in the hands of those who can use those rights most productively. Agency theory (Eisenhardt, 1989a; Fama & Jensen, 1983; Holmstrom, 1979; Holmstrom & Milgrom, 1991; Jensen & Meckling, 1976) studies the contractual relationship in which one party (the “principal”) delegates work to another (the “agent”). The focus of the theory is on determining the most efficient contract to govern a particular relationship given the characteristics of the parties involved and the fact that environmental uncertainty and the cost of obtaining information make it impossible for the principal to monitor the agent completely. Though most of the agency literature addresses explicit, formal contracts, it can also be used to evaluate implicit “social contracts” such as social norms, peer pressure and peer acceptance (White, 1985). Most agency models define efficiency from the principal’s point of view, and an efficient contract is one that brings about the best possible outcome for the principal, rather than one that maximizes the joint utility of both principal and agent (Bergen, Dutta, & Walker, 1992). Agency problems include precontractual problems that arise before the principal decides to offer an agent a contract and postcontractual problems, which emerge after the principal and agent engage in a relationship. Precontractual, or ex ante, problems tend to be emphasized, particularly in the more formal “principal-agent” branch of agency theory (Harris & Raviv, 1979).
The other branch of the new institutional economics is transaction cost economics (TCE), which operates in between the institutional and resource allocation levels on a governance level, where one is concerned with the play of the game (Williamson, 1998b, 2000). TCE again is split into a governance branch and a measurement branch (Williamson, 1985). The measurement branch (Alchian & Demsetz, 1972; Barzel, 1982) is concerned with the performance and attribute ambiguities associated with the supply of a good or service, and the measurement literature thus focuses on measurement costs. The governance branch (Klein et al., 1978; Williamson, 1975, 1979, 1985), which has become the dominant branch of transaction cost economics and to which this study belongs, emphasizes economic efficiency issues by comparing alternative forms of governance structures. Hence, it is more concerned with assessing transaction costs in a comparative institutional way, in which one mode of contracting is compared with another, than with determining the absolute magnitude of transaction costs. For the governance branch, it is the difference in rather than the exact size of transaction costs that matters.

2.2.2 The Fundaments for Oliver Williamson’s Key Contributions

Particularly for the development of the governance branch, the works of Oliver Williamson have been of key importance, and in 2009 he received the Nobel Prize in Economic Sciences for his contributions. His first two books in particular, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975) and *The Economic Institutions of Capitalism* (1985), are seminal, but also his third book, *The Mechanisms of Governance* (1996), contributed to a comprehensive transaction cost theory with testable implications.

In *The Economic Institutions of Capitalism*, Williamson dedicates the book as follows: “To my teachers: Kenneth J. Arrow, Alfred D. Chandler Jr., Roald H. Coase, Herbert A. Simon.” The work of these four scholars represents important parts of the basis for Williamson’s work. Williamson (1999b) points to Arrow’s work on market failure, in which Arrow observes that “market failure is not absolute; it is better to consider a broader category, that of transaction costs, which in general impede and in particular cases block the formation of markets” (1969:49). Chandler (1962) demonstrates that the organization form has important business performance consequences, and Williamson writes that “the mistaken notion that economic efficiency was substantially independent of internal organization was no longer tenable after the book appeared” (1985:11). Coase’s classic
article on “The Nature of the Firm” (1937) was the most prominent early
collection in the governance perspective, in which firms and markets are
described as alternative forms of governance, while his later article on “The
Problem of Social Costs” (1960) introduced the fiction of zero transaction
costs. And finally, Simon’s (1961) work on bounded rationality defines a
key behavioral assumption for Williamson’s work.

Among other key contributors to the basis for Williamson’s work were John
R. Commons, who identified the transaction as the ultimate unit of activity
(1934) and Chester Barnard, an early scholar who insisted on the importance
of organization and economizing (1938).

2.2.3 Efficiency
Transaction cost economics, as developed by Williamson (1975, 1985) and
Klein, Crawford and Alchian (1978), proposes that economic institutions
have the primary purpose of economizing on transaction costs and explains
differences in economic organization accordingly. It subscribes to
Commons’ view (1924, 1934) that the transaction is the basic unit of
analysis. Efficiency purposes are served by matching transaction governance
structures to the attributes of transactions. Identifying the critical dimensions
with respect to which transactions differ, as well as the strengths and
weaknesses of various governance structures, is therefore of great
operational significance. TCE emphasizes organizational features where
neoclassical economics focuses on technological features related to its basic
understanding of the firm as a production function. When firms expand
beyond what is seen as their natural boundaries, defined by a core
technology (Thompson, 1967), neoclassical economics presumes that such
behavior has a monopoly purpose and effect. TCE subscribes such behavior
to efficiency purposes. The firm may expand beyond its technologically
“natural” boundaries if this allows the firm to gain from first-order
economizing, i.e. the effective adaptation and the elimination of waste,
related to the transaction in question (Williamson, 1985).

2.2.4 Transaction Costs
Transaction costs have been defined as the “costs of running the economic
system” (Arrow, 1969:48). Such costs are different from production costs,
which is the cost category with which neoclassical analysis has been
preoccupied, whereas transaction costs may best be understood as the
economic equivalent of friction in physical systems (Williamson, 1985:19).
As physicists have successfully used the unrealistic assumption of “no friction” to understand the attributes of complex systems, neoclassical economists have assumed “no transaction costs” in their models.

Williamson (1975, 1985) distinguishes transaction costs as either *ex ante* or *ex post* types. Ex ante transaction costs include the costs of drafting, negotiating, and safeguard an agreement. *Drafting* may be done with a great deal of care, resulting in complex documents in which numerous contingencies are recognized and appropriate adaptations by the parties are stipulated and agreed on in advance, or it may be done with less care, using simple and incomplete documents so that the gaps have to be filled in by the parties as the contingencies arise. Drafting complex documents result in significant ex ante transaction costs, while simple documents reduce such ex ante transaction costs. *Safeguards* can take many forms, the most obvious being common ownership. Parties to a transaction anticipating contracting difficulties may substitute internal organization for the market. Interfirm safeguards include signaling credible commitments. Safeguards are important because unlike neoclassical economics and many other studies of economic exchange, transaction cost theory does not assume that efficacious rules of law regarding contract disputes are in place and being applied by the courts in an informed, sophisticated, and low-cost way. In the transaction cost literature, it is assumed that individual parties to an exchange may contract away from the governance structures of the state by devising private orderings (Klein, 1980; Telser, 1980; Williamson, 1983, 1985).

Ex post transaction costs include maladaptation costs, haggling costs (incurred if parties seek to correct ex post misalignments), setup and running costs for the governance structure and the bonding costs of effecting secure commitments (Williamson, 1985). Suppose that a contract stipulates x but that the parties in hindsight recognize that they should have done y, getting from x to y may then not be easy. The manner in which the associated benefits are divided is apt to give rise to intensive, self-interested bargaining (haggling costs). An incomplete adaptation will be realized if the parties move not to y but to y’ (maladaptation costs).

Ex ante and ex post transaction costs are interdependent and should therefore be addressed simultaneously rather than sequentially. Reducing the ex ante costs of drafting may for example result in higher ex post haggling costs.
Transaction costs include both the *direct costs* of establishing and managing relationships and the possible *opportunity costs* of making inferior governance decisions.

**2.2.5 Behavioral Assumptions**

Transaction cost theory assumes *bounded rationality* and *opportunism*. The cognitive assumption of bounded rationality is a semi-strong form of rationality in which economic actors are assumed to be “intendedly rational, but only limitedly so” (Simon, 1961:xxiv). With limited rationality comprehensive contracting is not a realistic organizational alternative since it is impossible for an economic actor who is intended rational, but only limited so, to foresee any and all contingencies when drafting a contract. The cognitive constraints become particularly problematic in uncertain environments, in which circumstances surrounding an exchange cannot be specified ex ante (i.e. environmental uncertainty) and performance cannot be easily verified ex post (i.e. behavioral uncertainty). Transaction cost economics is concerned with the economizing consequences of assigning transactions to governance structures in a discriminating way. Confronted with the realities of bounded rationality, the costs of planning, adapting and monitoring transactions need to be expressively considered. Everything else being equal, contracting modes that make large demands against cognitive competence are relatively disfavored (Williamson, 1985).

Transaction cost theory subscribes to the strongest form of self-interest seeking, opportunism. Williamson (1985:47) defines it as “self-interest seeking with guile”: “This includes, but is scarcely limited to the more blatant forms, such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit. Both active and passive forms and both *ex ante* and *ex post* types are included.” In the transaction cost literature, opportunism typically refers to the incomplete or distorted disclosure of information, especially in relation to calculated efforts to mislead, distort, disguise or otherwise confuse. It is responsible for real or contrived conditions of information asymmetry that vastly complicate problems of economic organization. Transactions that are subject to *ex post* opportunism will benefit if appropriate safeguards can be devised *ex ante*. Opportunism poses significant problems for transactions supported by specific assets whose value is limited outside the specific relationship (Klein et al., 1978). Specific assets “lock” the parties into the transaction; market competition can therefore no longer serve as a restraint on opportunism. This lock-in
effect is what Williamson refers to as the *fundamental transformation* (1985:61).

Assuming bounded rationality and opportunism, it also becomes difficult for the transactors to communicate their plans in such a way that an uninformed third-party, such as a court, could reasonably enforce them. Hence, it is difficult for a third-party enforcer to verify the parties’ claims in the event of a dispute (Lewis & Sappington, 1991).

### 2.2.6 Governance Forms and Transaction Attributes

Transaction cost economics holds that transactions that differ in their attributes are aligned with governance structures that differ in their costs and competence in a discriminating way (Williamson, 1991, 1999a). This view implies that the degree to which transactions are governed by vertically integrated hierarchies or left to the market is largely determined by the nature of the transaction.

As reflected by the title, in *Markets and Hierarchies*, Williamson, as Coase did, considers markets and hierarchies as the alternative governance forms. He only briefly discusses intermediate forms such as long-term contracts (1975:87), but it should be noted that he does suggest empirical studies of quasi-integrated modes of organization for further research (1975:263). The focus on markets and hierarchies is carried forward in *The Economic Institutions of Capitalism*, even though here he includes more thorough discussions of intermediate types in the form of nonstandard contracting such as the use of franchises in cable TV (Williamson, 1985:352). However, in response to criticism for dealing with the polar forms while neglecting the intermediate forms, Williamson (1991) introduces the hybrid form into his models, now distinguishing between three generic forms of governance — market, hybrid and hierarchy.

Following Masten’s (1988) recognition of different governance forms being supported by different legal regimes, Williamson (1991) argues that each of these three generic forms needs to be supported by a different form of contract law and that they are intrinsically different from each other because they are supported by different forms of contract law. Classical contract law applies to market transactions. In such transactions, there are no dependency relationships between buyers and sellers. These transactions are monetized to an extreme degree; contract law is interpreted in a very legalistic way;
more formal terms supercede less formal, and they are characterized by hard bargaining (Macneil, 1974, 1978).

Neoclassical contract law and the excuse doctrine support the transactions governed by hybrid structures. This form of contract law relieves parties from strict enforcement and applies to contracts in which the parties maintain autonomy, but are bilaterally dependent on each other to a nontrivial degree. Contracts are mediated by an elastic contracting mechanism. This contract regime is therefore better suited for transactions in which efficient coordinated adaptation is important (Williamson, 1991). This is typically the case for long-term, incomplete contracts that require special adaptive mechanisms to effect realignment and restore efficiency when beset by unanticipated disturbances. The long-term contractual relationship between General Motors and Fisher Body prior to the 1926 merger has been widely studied by transaction cost economists, mostly for its failure to offer the required adaptation and realignment (Coase, 2000; Klein, 1988, 2000; Klein et al., 1978), but Williamson (1991) uses a 32-year coal supply agreement between the Nevada Power Company and the Northwest Trading Company as an illustrative example. This latter contract contemplates unanticipated disturbances for which adaptation is needed, provides a tolerance zone within which misalignments will be absorbed, requires information disclosure and substantiation if adaptation is proposed and provides arbitration in the event a voluntary agreement fails. As seen in this example, within the neoclassical contract regime disputes are referred to arbitration rather the courts, whereas disputes under the classical contract law regime governing market transactions is referred directly to the courts. While arbitration is costly to administer, it is generally more efficient and economical than the courts. The hybrid structure thus offers more efficient coordinated adaptation than the market structure, even if the parties to a transaction should end up in a dispute. Long-term contracts, franchises, partnering and alliances are typical examples of hybrid governance structures - also referred to as relational governance in parts of the transaction cost literature.

The implicit contract law of hierarchy or internal organization is that of forbearance. The courts will refuse to hear disputes between one internal division and another, and as access to the courts is being denied, the parties must resolve their differences internally. Accordingly, hierarchy is its own court of ultimate appeal (Williamson, 1991). The underlying rationale for
forbearance law is twofold: (1) parties to an internal dispute possess a deep knowledge that can be communicated to the court only at a great cost, and (2) permitting internal disputes to be appealed to the court would undermine the efficacy and integrity of hierarchy or internal organization. Under the forbearance regime, parties to an internal exchange can work out their differences (e.g. appropriate transfer prices, the damages to be ascribed to delays, failures or quality) themselves or appeal unresolved disputes to the hierarchy for a decision. But this exhausts their alternatives. Consequently, firms can and do exercise authority relationships that markets cannot.

The primary benefits of hierarchy stem not from ownership or integration per se, but rather from the ability to exercise decision control (Heide, 1994). Since the ability to govern by means of authority is not limited to intrafirm settings but also can be achieved between firms by means of contractual provisions (Stinchcombe, 1985), the key distinction between the most integrated types of contractual hybrids and hierarchy is that the first is based on neoclassical contract law and the excuse doctrine, while the latter is based on forbearance.

The two polar governance structures are market and hierarchy. Compared to markets, hierarchies have superior abilities to minimize the transaction costs that arise due to a lack of adaptation from disturbances that require cooperation and coordinated responses. This is because organizations have more powerful control and monitoring mechanisms; they can provide rewards that are long term in nature, and they provide an organizational atmosphere and culture that may create convergent goals between parties. These organizational abilities represent potential transaction costs savings by reducing the opportunity costs raised by an ill adaptation to disturbances requiring a coordinated adaptation. However, the advantages of these organizational abilities come at the direct cost of running an organization and the indirect costs of: (a) giving up the high-powered incentive structures of the market, and (b) a relatively weaker ability to adapt to market changes (i.e. changes in the demand or supply of a commodity or service). The relevant tradeoff is therefore that of one between the costs represented by ill coordinated adaptations and these hierarchal costs. Transaction cost theory does recognize the production cost advantages of market procurement such as economies of scale and scope. Accordingly, transaction will be organized in markets unless transaction cost disabilities appear (Williamson, 1981b).
One may thus say that the default governance structure is market governance.

While Williamson (1991) refers to market, hybrid and hierarchy as three distinct governance structures for analytical purposes, one may also consider structures along a continuum with market and hierarchy at each polar end (Gatignon & Anderson, 1988; Klein, 1989; Masten, Meehan, & Snyder, 1989).

According to transaction cost theory, the most efficient governance structure is determined by the attributes of the particular transaction. The principal dimensions with which transactions differ are asset specificity, uncertainty and frequency (Williamson, 1975, 1985).

Asset specificity refers to investments in specific assets that support the transaction in question. If assets are redeployable outside the context of the transaction without sacrificing productive value, they are not transaction specific. If they cannot be redeployed without a loss of productive value, they are transaction specific. Assets with a high degree of specificity represent sunk costs that have little value outside a particular exchange relationship. Such assets create a bilateral dependency between the transaction parties and therefore added contracting hazards, as in the form of opportunistic appropriation (Joskow, 1988; Klein et al., 1978). Without suggesting to be exhaustive, Williamson (1996) identifies six types of asset specificity: (1) site specificity, as to where successive stages of production are located together to economize on inventory and transportation expenses, (2) physical asset specificity, such as specialized dies that are required to produce a component, (3) human asset specificity, which arises in a learning-by-doing fashion, (4) dedicated assets, which are discrete investments in general purpose plants that are made at the behest of a particular customer to which (5) brand name capital and (6) temporal have been added.

The importance of transaction-specific investments or asset specificity to transaction cost economics is difficult to exaggerate, and asset specificity is also the principal factor with which transaction cost economics explains vertical integration. In general, hierarchy is favored in situations where asset specificity is great due to the associated ex post appropriability hazards for the quasi rents created (Klein et al., 1978), and because the high degree of bilateral dependency that exists in those circumstances requires a
coordinated adaptation to disturbances (Williamson, 1985). It should be noted however that asset specificity increases the transaction costs of all forms of governance. Added specificity is hence only warranted if these added governance costs are more than offset by production-cost savings and/or increases in revenues. The relationship between asset specificity and governance costs and structure is illustrated below in the Figure 2.2.

![Figure 2.2 - Governance costs as a function of asset specificity (Williamson, 1991:284)](image)

\[ M = M(k;\theta), X = X(k;\theta), \text{ and } H = H(k;\theta) \] are reduced form expressions that denote market, hybrid and hierarchy governance costs as a function of asset specificity \((k)\) and a vector of shift parameters \((\theta)\). Two relationships are important (Williamson, 1991):

\[ (2.1) \, M(0) < X(0) < H(0) \]

With no asset specificity \((k=0)\), market will have the lowest governance cost, followed by hybrid and hierarchy, because there is no or little bilateral dependency between the transaction parties and thus no need for a
coordinated adaptation to disturbances. With no asset specificity, the most important attribute to the governance structure is its ability to let each transaction party effectuate an autonomous adaptation to market disturbances; in this respect, market governance is superior to hybrid and hierarchy.

\[(2.2) M' > X' > H'\]

When asset specificity is introduced it creates a bilateral dependency, and the ability of each form of governance structure in effectuating a coordinated adaptation to disturbances becomes important. Since hierarchy has superior coordinated adaptation abilities, it has the lowest marginal increase in governance costs as asset specificity increases. Hybrid structures can effectuate a coordinated adaptation more efficiently than market structure, but less efficiently than hierarchy.

At a certain level of asset specificity \((K_1)\), the governance costs of market governance will have increased to equal the governance cost of a hybrid structure. At a higher level of asset specificity \((K_2)\), hybrid governance costs have increased to equal hierarchy governance costs. Thus, at asset specificity levels from zero to \(K_1\), the market is the most efficient governance structure; at levels from \(K_1\) to \(K_2\), hybrid governance is most efficient, and at levels higher than \(K_2\), hierarchy will be most efficient.

The second principal dimension of a transaction is *uncertainty*, which Arrow (1974) identified as a fundamental driver of market frictions and one of the driving economic forces behind the formation of managerial organizations. Uncertainty is always assumed at some level in transaction cost theory, as uncertainty is the basis for adaptive, sequential decision-making (Williamson, 1985). The constraints of bounded rationality become problematic in uncertain environments, in which the circumstances surrounding the transaction cannot be specified ex ante (i.e. environmental uncertainty) and performance cannot be easily verified ex post (i.e. behavioral uncertainty). The primary consequence of environmental uncertainty is an adaptation problem, i.e. modifying agreements to changing circumstances. The effect of behavioral uncertainty is a performance evaluation problem, i.e. difficulties in verifying whether compliance with established agreements has occurred. The influence of uncertainty on economic organization is, however, conditional. Increased uncertainty has
little consequence for nonspecific transactions. With no asset specificity, new trading relations are easily arranged, continuity has little value and behavioral uncertainty is irrelevant. Accordingly, market exchange continues and the discrete contracting paradigm holds across standardized transactions of all kinds, whatever the degree of uncertainty (Williamson, 1985). For transactions involving specific assets, increasing the degree of uncertainty will make it more important for the parties to devise a governance structure to “work things out” since contractual gaps will be larger and the occasions for sequential adaptation will increase in number and importance as the degree of uncertainty increases. Concerns over behavioral uncertainty also become an important issue (Klein et al., 1978). The interaction effect with asset specificity will thus work so that the marginal increase in governance cost resulting from increasing asset specificity will be higher (i.e. the slope of the M(k), X(k), and H(k) in Figure 2.2 will be steeper and K$_1$ and K$_2$ will shift to the left with a higher degree of uncertainty).

Finally, the third principal dimension, the frequency of the transaction, is relevant to the tradeoff between the transaction cost savings obtained from hierarchy structures for nonstandard transactions and the cost of operating the hierarchy. The cost of organizational structure will be easier to recover for large transactions of a recurring kind (Williamson, 1985). The high governance cost of internal organization is generally not justified for infrequent transactions.

These three dimensions all affect the governance choice decision, which may also be influenced by other factors. TCE theory hence yields probabilistic, not deterministic, predictions (Masten, 2000). For instance, holding other things constant (uncertainty, frequency, complexity, etc.), the likelihood that a more integrated governance arrangement will be adopted increases when production involves large relationship-specific investments. Nonetheless, the theory cannot predict that such arrangements will be adopted.

2.2.7 Applications
Oliver Williamson (1985) proposes that any issue that can be formulated as a contracting problem can be investigated to advantage in transaction cost economizing terms. This very broad scope of the theory is reflected in the wide variety of academic disciplines beyond economics that have adapted the transaction cost approach. These include strategic management, accounting, sociology, political science, organizational theory, contract law,
international business, corporate finance and marketing. Empirical applications range from issues of marriage (Treas, 1993) to international trade (Hennart & Anderson, 1993) and are too widespread to be summarized here, but various reviews of the empirical TCE research provide an overview (David & Han, 2004; Joskow, 1988; Macher & Richman, 2008; Masten & Saussier, 2000; Rindfleisch & Heide, 1997; Shelanski & Klein, 1995). Only a selection of important early empirical articles in key areas of vertical and horizontal integration, as well as applications to strategic management, follows here.

The earliest and most common applications of transaction cost theory are vertical integration studies. These include both studies of a firm’s decision to backwardly integrate into the supply of materials or components (Joskow, 1985; Masten, 1984; Monteverde & Teece, 1982b; Walker & Weber, 1984) and studies of forward integration into distribution and sales (Anderson, 1985; Anderson & Coughlan, 1987; John & Weitz, 1988). Closely related to these are the vertical interorganizational relationship studies that focus on how governance problems can be managed without common ownership (Heide & John, 1988; Monteverde & Teece, 1982a). Issues here include the use of safeguards, relational contracting, the role of relational norms and the use of pledges in building credible commitments. While transaction cost scholars have traditionally focused on vertical interorganizational relationships, there are a growing number of studies focusing on horizontal interorganizational relationships seeking to understand and explain a variety of relationships between firms at the same point in the value chain. Adding and applying transaction cost principals to the neoclassical theory on scope economies, Teece (1980) first extended TCE to the horizontal analysis of multiproduct diversification, and among the better-known horizontal studies is Bucklin and Sengupta’s (1993) study, which explores the role of asset specificity, uncertainty and frequency on power imbalances in co-marketing alliances.

More recent research within strategic management applies TCE to consider the performance implications of organizational form. Leiblein et al. (2002) find that organizational governance influences technological performance in a way largely consistent with TCE predictions in the semiconductor industry. Measured in terms of post-alliance patent productivity, Sampson (2004) finds that alliances improve innovative performance when selected
according to TCE hazard mitigation arguments in the telecommunications industry.

TCE has also been applied successfully in combination with other theories of strategy such as the resource-based view (RBV), which has grown from Penrose’s (1959) early work. For example, Mayer and Salomon (2006) find that outsourcing to partner firms is more likely if firms possess superior capabilities, as capabilities help shape governance capabilities in selecting, monitoring and sharing knowledge with suppliers. Another study combining TCE with other traditions within strategic management is one by Nickerson et al. (2001), which links TCE with Porter’s (1985) strategic positioning framework (SPF) in an examination of the international courier and small package services industry in Japan. The authors argue that both TCE and SPF, if applied alone, lead to inferior statistical performance when compared with a joint positioning-economizing lens that better predicts firm’s choices on market position, resource profile and organization.
3 Conceptual Framework and Research Objective: A TCE-based Joint Value Approach

A primary strength of transaction cost theory is its ability to explain the relationship between transaction-specific investments or asset specificity on the one hand and transaction governance structure on the other (Williamson, 1999b), with the empirical support for its refutable predictions on this relationship generally being strong (David & Han, 2004; Macher & Richman, 2008; Rindfleisch & Heide, 1997). Hence, TCE offers a platform for a set of normative implications when choosing among alternative governance arrangements, and the theory has for instance been central in studies of interorganizational relationships in the alliances literature (Dyer & Singh, 1998; Kogut, 1988). Other contributions include research on make-or-buy decisions for firms considering backward vertical integration into the supply of materials or components (Lieberman, 1991; Masten et al., 1989; Monteverde & Teece, 1982b), research on forward vertical integration focusing on manufacturers’ choice of integrating distribution functions (Anderson, 1985; John & Weitz, 1988; Weiss & Anderson, 1992), as well as a related branch of research focusing on foreign market entry modes (Anderson & Coughlan, 1987; Anderson & Gatignon, 1986; Klein, 1989; Klein & Roth, 1990; Petersen, Welch, & Benito, 2010).

However, the reverse relationship embedded in the theory – how the level of transaction-specific investments is affected by governance structure – is not well explored. As first pointed out by Bensaou and Anderson (1999), and more recently by Macher and Richman (2008) and Kang et al. (2009), little attention has been focused on the origins of transaction-specific investments generally within the transaction cost literature. Yu and Liao (2008) set out to explore the impact of governance mechanisms on transaction specific investments and find a positive relationship. However, their cross-sectional analysis only tests hypotheses of positive correlations and fails to confirm the directionality of the relationship. Thus, the causality is not empirically grounded but limited to their reasoning. Furthermore, Maches and Richman (2008) identify the almost exclusively exogenous treatment of asset specificity and the level of a firm’s investment in those as an important gap in the existing empirical literature. Given the importance of specific investments, which generally enhance productivity and value creation
(Bensaou & Anderson, 1999; Williamson, 1985), a better understanding of their origins and the further development of the reverse relationship between governance structure and specific investments would add significantly to TCE’s power as a guide to strategic management.

For instance, a focal firm in an alliance dyad may experience governance structure and relationship-specific investments as equal choice variables. Specific investments, or the investment decisions, may or may not be made prior to that of governance structure (Kang et al., 2009; Williamson, 1999b), and the overwhelmingly exogenous treatment of specific investments in the literature therefore seem in need of being balanced by a more endogenous treatment. For the focal firm, the ultimate objective will be neither governance structure nor specific investments, but realized gain by entering into or continuing the alliance. According to Williamson (1999b), governance is a means to accommodate opportunities, including that of making relationship-specific investments, to realize mutual gains. Hence, for the alliance dyad the objective will be to maximize joint value (Ghosh & John, 1999, 2005; Zajac & Olsen, 1993).

Zajac and Olsen (1993) introduced their transaction value analysis framework as an alternative to TCE, which they criticized for neglecting transaction partners’ interdependent pursuit of joint value. Nevertheless, it is argued here that their criticism confuses the largely reduced form of exogenous treatment of specific investments in the empirical literature with the more nuanced treatment in transaction cost theory. If specific investments are treated as being endogenous, as Macher and Richman (2008) argue they should be, there is not necessarily any conflict between TCE and the transactional value analysis proposed by Zajec and Olsen.

A better understanding of the origins of specific investments within the context of transaction cost theory will increase the transaction cost theory’s explanatory power and expand its applications into studies of how such investment needs may be facilitated, thereby broadening the strategic scope from being primarily those of governance decisions to also including those of investment decisions. And the investment decisions are not of less significance than the governance decisions, as the ultimate goal guiding both is to maximize transaction value. Moreover, investing in specific assets may be seen as expanding a firm’s strategic core (Reve, 1990), a decision which is clearly not trivial in terms of strategy. Variables other than governance
structure may of course be found to have a significant impact on transaction-specific investments, but since the relationship between asset specificity and governance structure has a key position in the theory, it is a good place to start.

3.1 The Value of Transaction-Specific Investments

Asset specificity is created when a transaction partner makes an investment into assets that can only be redeployed outside the transaction context with a significant reduction in productive value or at significant direct costs. The empirical transaction cost literature catalogues many examples of both tangible and intangible specific assets. Pirrong (1993) offers a relatively extreme though unambiguous example in the enormous oceangoing cargo ships fitted to maximize the efficient Pacific crossing, loading and unloading of Honda Accords and nothing else. While such a ship is clearly of great use to the Accord division of Honda, it is far less efficient in other applications. It may transport other cars, but with much less efficiency than it transports the Accords (i.e. it may be redeployed, but with a significant reduction in productive value). Overcoming these inefficiencies would involve expensive retrofitting (i.e. redeployed at significant direct costs). In the motion picture sector, cinemas represent a similar but maybe somewhat less extreme example of tangible transaction-specific assets. A multiplex cinema building can only be used for purposes other than showing movies with a substantial loss in productive value. Alternatively, it may be refitted for other use, but only at a substantial direct cost.

Transaction-specific assets are cospecialized to fit the needs of the transaction parties. In the cargo shipping example above, the ship is specialized for the shipping company, which can offer Honda’s Accord division more competitive transportation than shipping companies operating “general purpose” car transportation vessels due to its ability to transport Honda Accords more efficiently, in addition to the fact that it is also specialized for Honda, which can cover their transportation needs more efficiently than they would if no special purpose vessels were available. In the movie business example the movie exhibition venue is co-specialized to fit the needs of the firm owning cinemas, which obviously can offer movie suppliers more competitive movie presentation facilities than owners of other types of real estate, and the firm supplying the movie (the distributor),
which benefits from cinemas as efficient venues to reach its customers, the audience.

The transaction parties in both the shipping and movie examples may be part of the same corporation. Honda may own the shipping unit that operates the special purpose vessel, and a movie distributor may also own the cinemas. Indeed, TCE will predict, other things being equal, that with high levels of asset specificity integrated structures will offer the most efficient governance (Williamson, 1975, 1985, 1991). The main point here, however, is that the presence of the transaction-specific investments is valuable to both transaction partners since the specific assets allow them to effectuate the transaction more efficiently than would have been possible without such assets.

3.2 Joint Value and Transaction Costs

The connection between joint value and transaction costs is well explained by Ghosh and John (1999). Like Williamson (1996) they observe as a starting point that transaction cost economics can be summarized as unpacking the ramifications of the Coase-theorem. According to this theorem, in the absence of transaction costs, parties to an exchange will devise joint value maximizing transactions regardless of their power differentials or resource endowments. Since transaction costs are never really at zero, it is the subsequent implications for nonzero transaction cost worlds that are really of interest. With positive transaction costs, the core principle of transaction cost theory is that parties will strive to align governance forms with exchange attributes to minimize the transaction costs of exchange. And they do so because such an alignment gets them closer to the desired goal of joint value maximization. Reducing transaction costs results in increasing joint value.

Bensaou and Anderson (1999) argue that co-specialized assets generate enormous added value in terms of production cost savings and product differentiation. So, while asset specificity increases transaction costs as demands for safeguards increase, it reduces production costs. While TCE focuses on transaction costs, it does not ignore production cost issues. Organizing commercial transactions in an efficient cost-economizing manner takes two parts: economizing on production expense and economizing of
transaction costs. These are not independent and need to be addressed simultaneously (Riordan & Williamson, 1985; Williamson, 1981b).

Both production cost savings and product differentiation effects are illustrated in the Honda Accord vessel and cinema examples. The justification of making specific investments by production cost considerations is found in the special purpose vessel case in the transportation cost savings realized by employing such specialized vessels. Similarly, with a real estate property specifically fitted for the exhibition of motion pictures, one may exhibit movies to paying patrons for a much lower per-customer cost than what is possible without such specific assets (e.g. through special “open air” screenings, etc.). Typically, the more specified the assets, the bigger the production cost savings that may be realized. More formally, one may say that the production cost (PC) curve set up as a function of asset specificity has a negative slope (PC’ < 1).

In the cinema case one may consider two commonly appearing alternatives: In one case, one may have a city center single screen cinema that may also be used, or which maybe has previously been used, for live theater or other live performances. In another case, one may have a so-called megaplex theater (a cinema with 14 or more screens). The latter is more specialized since good alternative uses are more difficult to find, but it offers considerably larger “production cost” savings than the single-screen cinema since it can realize economies of scale by serving more patrons from common support facilities (e.g. the box-office, bath-rooms, concession stands, projection booths, etc.) (AMC, 2002). In the special purpose vessel example, product differentiation is clearly obtained by being able to offer the Accord division of Honda transportation facilities that are different from and superior to any other kind of ship on the market. And cinema owners are likewise able to offer real estate facilities that for the purpose of movie exhibition are different from and superior to any other kind of real estate on the market. Generally, the alternative to the use of specific assets is using general-purpose assets, which implies fewer possibilities for product differentiation.

While transaction-specific investments are valuable to the transaction parties, these investments are also very vulnerable. This is because once the investment has been made, the transaction parties are effectively operating in a bilateral (or at least quasi-bilateral) exchange relationship for a
considerable period thereafter (Williamson, 1981b). They are “locked into” the transaction. Slipping into a small-numbers bargaining position, the parties are subjects to both the dangers of behavioral uncertainty (opportunism) and environmental uncertainty. The danger of opportunism is obvious: Specific investments cannot easily be redeployed to any other transaction partner and the current transaction partner may therefore, at least up to a point, breach its promises, knowing that the other party is better off tolerating such opportunistic behavior than attempting to punish it. Research on the contracting between multi- and megaplex cinema owners and operators in the UK indicates such opportunistic behavior. Cinema operators may argue that the return earned on the property does not support rent escalators built into the long-term leases. Due to the inflexibility of these real estate structures and the absence of alternative tenants, owners may choose to settle for less favorable terms than those actually stipulated in the contract (Sayce, Smith, & Walker, 2001). However, the strategic hazards arising from the non-redeployable character of specific assets are very much present even without opportunistic behavior, simply because of environmental uncertainty. A good example is found in Bensaou and Anderson’s (1999) empirical research on the auto industry: Toyota lost a week of production when Aisin, its proportioning valves supplier, suffered a factory fire. No cars could be produced until alternative suppliers could be brought up to speed.

Transaction-specific investments thus pose the following dilemma: On the one hand, there are ex post out-of-pocket costs from opportunistic behavior and environmental uncertainty. On the other hand, scaling back these investments or forgoing the deal altogether involves ex ante opportunity costs. The key question is whether the prospective cost savings afforded by special purpose assets justify the strategic hazards that arise as a consequence of their nonsalvageable character. A tradeoff is therefore posed and needs to be evaluated (Ghosh & John, 1999; Williamson, 1985). This may be seen as a tradeoff between production economies and transaction cost economies (Williamson, 1981a).

3.3 Exogenous and Endogenous Treatments of Transaction-Specific Investments

Coping with the tradeoff between the prospective cost savings and strategic hazards posted by transaction-specific investments, the transaction parties are motivated to devise governance forms that possess sufficient safeguards
to secure these valuable but vulnerable investments in order to minimize total transaction costs, including ex post costs due to opportunistic behavior and ex ante opportunity costs of foregone investments or deals (Klein et al., 1978; Williamson, 1975, 1985). Although the empirical work on this particular prediction is quite significant and shows consistent support, virtually all the studies rely on a reduced-form version of the prediction; namely, the presence of larger specific investments will be associated with stronger governance safeguards (David & Han, 2004; Macher & Richman, 2008; Rindfleisch & Heide, 1997). Through tests of this reduced-form prediction, the transaction-specific investments appear to be exogenous, and the very reason for the specific investments is obscured (Ghosh & John, 1999).

This reduced-form exogenous treatment of transaction-specific investments found in most of the empirical material has caused some confusion and invited counterarguments from critics. Particularly relevant to this study is Zajac and Olsen’s (1993) criticism, which claims that the transaction cost approach neglects the issue of joint value. Instead of a transaction cost approach, they propose a transaction value framework that emphasizes joint value maximization and the process by which exchange partners create and claim value. As discussed above, also emphasizing joint value maximizing, but within the framework of mainstream transaction cost theory, Ghosh and John (1999) argue that joint value is created when transaction costs are reduced and that Zajac and Olsen’s criticism is not consistent with transaction cost theory, but that it originates from a misunderstood reading of the reduced-form empirical work. Much of Zajac and Olsen’s criticism seems to be based on an assumption of an exogenous treatment of specific investments in transaction cost economics. For example, they argue that in a situation in which transaction parties consider two alternatives of interorganizational governance, in which one form involves a substantial committed investment that will benefit the performance of both companies, a pure transaction cost analysis would favor the other because the committed investment entails substantial transaction costs. They conclude: “[…] when the pursuit of transaction value necessitates higher transaction costs, and expected joint gains outweigh transaction cost considerations […], interorganizational strategies having greater joint value will typically require the use of less efficient (from a transaction cost perspective) governance structures” (p.138). This argument is not only based on an assumption that
transaction cost economics does not allow for an endogenous treatment of specific investments, but it also ignores transaction cost theory’s explicit treatment of the tradeoff between production economies and transaction cost economies. A sound transaction cost treatment of the problem posted in Zajac and Olsen’s example would consider both the opportunity cost of foregone investments (or production economies effects) and the ex post transaction cost of alternative governance structures.

Allowing for an endogenous treatment of specific investments, the above problem may be analyzed in a transaction cost framework without any conflict between transaction cost and joint value considerations. First, based on transaction cost reasoning, assume a relationship between governance structure and transaction-specific investments in which more integrated structures have a positive effect on the level of transaction-specific investments. The logic is that by providing stronger safeguards for such investments, integrated structures create exchange environments in which transaction partners have stronger incentives to invest in specific assets, thereby reaping production economic benefits. Building on this assumption, one may analyze a stylized example resembling the situation referred to by Zajac and Olsen above. The two parties to a transaction are considering two alternative governance structures: Alternative A is closer to a market transaction mode and reflects a lesser degree of integration between the parties, while alternative B is closer to a hierarchical transaction mode and reflects a higher degree of integration. Choosing alternative A, the transaction parties will enjoy lower governance costs directly from saving the costs of operating a hierarchical structure. Furthermore, with the assumed relationship between governance structure and specific investments, the transaction parties will invest less in specific assets with this governance alternative. Since asset specificity generally increases governance costs, less transaction-specific investments will imply lower governance costs. However, low asset specificity will not yield the production economies one could realize with a higher level of transaction-specific investments. In sum, alternative A offers lower governance costs but not the benefits from said production economies. Choosing alternative B, the transaction parties will carry higher governance costs just from the hierarchical costs of a more integrated structure. With the assumed positive relationship between more integrated structures and the level of transaction specific investments, transaction parties choosing this alternative will invest
more in specific assets. A higher level of asset specificity will entail increased governance costs. However, the transaction parties will realize production economies from their specific investments. In sum, alternative B will imply higher governance costs, but let the transaction parties realize more favorable production economies.¹

![Figure 3.1 - Stylized example for alternative governance structures](image)

For a more formal comparative analysis of the two structural alternatives, the governance costs carried by the transaction parties if they choose alternative A may be labeled GCₐ. Choosing alternative B, they will endure higher governance costs, labeled GCₐ. The governance cost savings realized by choosing A instead of B may be labeled ΔGCₐₐ.ₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐₐ¢

¹Better production economies will be realized through production cost savings and/or through creating higher joint value (by creating an end product more valuable to end consumers).
realized by choosing B instead of A ($\Delta PC_{B-A}$) equal the production costs incurred with little specific assets in alternative A ($PC_A$) minus the production costs incurred with more specific assets in B ($PC_B$) as follows:

(3.2) $\Delta PC_{B-A} = PC_A - PC_B$

To optimize joint value, the transaction has to be organized in a cost economizing way (Ghosh & John, 1999). This requires economizing both production expense and transaction costs (Williamson, 1981b). Labeling the sum of production and governance costs combined costs (CC), the combined costs in alternative A ($CC_A$) equals the sum of governance costs of structure A ($GC_A$) and the production costs of structure A ($PC_A$). It follows from (3.2) above that the production costs of structure A equal the production costs of structure B plus the production cost savings of moving from A to B ($\Delta PC_{B-A}$). The combined costs of structure A may therefore be expressed as follows:

(3.3) $CC_A = GC_A + PC_B + \Delta PC_{B-A}$

Similarly, the combined costs of structure B ($CC_B$) equal the governance costs of structure B ($GC_B$) plus the production costs of structure B ($PC_B$). It follows from (3.1) above that the governance costs of structure B equal the governance costs of structure A plus the governance cost savings realized by choosing A instead of B. The combined costs of structure B may therefore be expressed as follows:

(3.4) $CC_B = GC_A + \Delta GC_{A-B} + PC_B$

The benefit, if any, to the transaction parties of choosing structure B instead of A, may therefore be expressed as the reduction in combined costs, if any, obtained by moving from A to B:

(3.5) $\Delta CC_{B-A} = CC_A - CC_B$

$= [GC_A + PC_B + \Delta PC_{B-A}] - [GC_A + \Delta GC_{A-B} + PC_B]$

$= \Delta PC_{B-A} - \Delta GC_{A-B}$

From (3.5), one sees that there will be a net benefit for the transaction partners or a gain in joint value from choosing structure B instead of A if the production cost savings associated with structure B ($\Delta PC_{B-A}$) are greater than
the governance cost savings associated with structure A ($\Delta GC_{A,B}$). However, if the difference in governance costs ($\Delta GC_{A,B}$) is greater than the difference in production costs ($\Delta PC_{B,A}$), then the net effect of moving from A to B ($\Delta CC_{A,B}$) is negative and the transaction parties should choose structure A. The net benefit of choosing one structure instead of the other will guide the transaction parties in the choice between the two alternatives:

(3.6) if $\Delta CC_{B,A} > 0$ (i.e. $\Delta PC_{B,A} > \Delta GC_{A,B}$), choose alternative B

(3.7) if $\Delta CC_{B,A} < 0$ (i.e. $\Delta PC_{B,A} < \Delta GC_{A,B}$), choose alternative A

Generally, given the assumed relationship between governance structure and specific investments, the above analysis shows that if the production cost savings realized with a more integrated governance structure are greater than the added governance costs following from such governance structure, the transaction parties would benefit from choosing this integrated structure. And this is basically an unpacking of the key tradeoff issue posted by Williamson (1985) with regard to transaction specific investments: “Do the prospective cost savings afforded by the special purpose technology justify the strategic hazards that arise as a consequence of their nonsalvageable character?” (p.54).

Production cost savings are used here to denote the production economies of enhanced productivity and value creation that entail specific investments. The tradeoff is thus more fully understood as a tradeoff between governance economies and production economies.

The analysis of this stylized example illustrates how important it may be to treat transaction-specific investments as a dependent variable when analyzing joint value issues. With an exogenous treatment of transaction-specific investments the above analysis would fall apart. With specific investments given, the production cost savings ($\Delta PC$) would also be given and not be dependent on the choice of governance structure. It is implied in Zajac and Olsen’s (1993) criticism of transaction cost economics that the theory does treat asset specificity as a given, and that it thus ignores production cost savings derived from transaction-specific investments. Taking the effects of production economies ($\Delta PC$) out of the above analysis and only focusing on direct governance cost savings ($\Delta GC$), one would arrive at the same conclusion as Zajac and Olsen, namely that “transaction
value” would suffer from pure “transaction cost considerations,” which would guide the transaction parties towards alternative A.

3.4 Loss of Production Economies as a Transaction Cost

Borrowing Ghosh and John’s (1999) argumentation, one may fit the joint value maximizing argument involving effects of production economies into the mainstream transaction cost framework. In a neoclassical framework in which the unit of analysis is the firm straightforward production cost thinking is unproblematic. However, fitting the full argument into a transaction cost framework requires that one also adapt to transaction cost theory’s unit of analysis, which is the transaction. In this framework, the potential loss of production economies effects is recognized as an ex ante transaction cost, namely the opportunity cost of foregone investments. Following this approach, one may bring the full production economies considerations in the above analysis into a mainstream transaction cost framework without having to deal explicitly with production economies in addition to transaction cost economies. This solves the unit of analysis problem, allowing the full analysis to be carried out with a focus on the transaction, and not on the firm. With the assumed relationship between governance structure and transaction-specific investments, the foregone production cost savings from utilizing specific assets becomes an opportunity cost of choosing certain types of governance structures (i.e. less integrated structures). Including this ex ante transaction cost into an analysis of the total transaction costs, one will maximize joint value by minimizing transaction costs.

One should note that arriving at this result is also the intention of Zajac and Olsen’s (1993) transaction value framework. They propose this as “a framework that views the cost of addressing transaction cost concerns (i.e. the risk of exploitation by one’s exchange partner) as simply a subset of total costs to be aggregated and then compared with the set of total benefits/gains in an overall calculation of the value of an interorganizational strategy” (p.133). Since they fail to recognize the opportunity costs of foregone investments as an ex ante transaction cost, they claim that this cannot be done solely within the framework of transaction cost theory.
For the sake of convenience, I will be referring to production economies in the following, even though it more precisely may be described as an ex ante transaction cost as discussed above.

3.5 Research Objective: From Governance Alignment to Transaction Value

TCE proposes that economic institutions have the primary purpose of economizing on transaction costs, and efficiency purposes are served by matching transaction governance structures to the attributes of the transactions, of which specific investments, uncertainty and frequency are considered the most important. In the relationship between structure and specific investments, it is not surprising then that attention first and foremost has been given to the effect of transaction-specific investments on governance structure, and with strong empirical support, the theory’s guidance on this particular relationship may be seen as the key TCE contribution to strategy.

Nonetheless, it is argued above that this approach needs to be complemented with an endogenous treatment of transaction-specific investments. This will allow us to shift focus from governance alignment, with which the influential reduced-form analysis proposed by Williamson (1991) is primarily concerned, to the more strategically interesting underlying objective of maximizing transaction value. The above analysis has shown that to achieve this objective, the key tradeoff to be considered is one between governance economies and production economies. The reduced-form analysis largely ignores the latter, while the model suggested here endeavors to provide a fuller analysis that makes allowances for both.

My proposed model based on the analysis above is illustrated in Figure 3.2 below. Drawing on the reduced form analysis, it shows that governance economies are affected by governance structure and specific investments, that structure is affected by specific investments, and that the effect of enhanced governance economies is increased transaction value. However, it explicitly adds production economies as a key variable, and shows that these depend on specific investments and that they affect transaction value. And since transaction value is determined by the sum of production and governance economies, the marginal tradeoff between the two identified in Section 3.3 above becomes decisive when seeking to maximize transaction
value. Finally, the model makes specific investments dependent on structure. Without this latter relationship, the model would fall subject to Zajac and Olsen’s (1993) criticism, and the marginal tradeoff between production and governance economies would also be void as discussed in Section 3.3 above.

**Figure 3.2 - Framework for a TCE-based transaction value analysis**

The proposed model rests on an *assumed* relationship between governance structure and specific investments in which more integrated structures have a positive effect on the level of transaction-specific investments. The assumption is based on transaction cost theory, with the causality primarily founded on the effects of added safeguards provided by more integrated structures. Given the empirically established correlations between specific investments and governance structures the assumed relationship seems likely. However, since the TCE literature’s treatment of specific investments has been almost entirely exogenous, the causality is not empirically grounded and its explanatory power is accordingly limited.

Hence, while the overall objective of this study is to shift the focus from governance alignment to the ultimate goal of maximizing transaction value, it can only be reached by applying an endogenous treatment of transaction-specific investments. Through a micro-analytic investigation of the heretofore assumed effects of governance structure on specific investments, my empirical work seeks to explain the causality of the relationship and therefore also to validate the proposed model.
The endogenous treatment of transaction-specific investments is applied within the context of the motion picture industry. In the following two chapters, it will be shown that motion picture production and distribution investments are largely specific to the transaction between the producer and distributor of a movie. The transaction value of a production-distribution transaction is thus closely linked to the joint value created by the producer and distributor(s) through their joint cooperative investments. It is the aggregate of these distribution and production investments that affects the attractiveness of the movie and its expected market performance, and in Chapter 1 the cumulative output of production and distribution function value creation, the joint product, was labeled the movie’s image (see Table 1.1). The transaction value of these production-distribution transactions is determined by this cumulative value creation into the joint product (the production economies) minus the transaction costs incurred by producer and distributor (the governance economies). It is therefore important not only to understand the well-established relationship between the producer and distributor’s respective specific investments and their contracting options, which enable us to carry out comparative transaction cost analyses, but also the reverse relationship of how different contracting options are likely to influence the parties’ respective investments in the joint product. A better understanding of this reverse relationship between production-distribution structure and production-distribution investments is necessary to align structure with the sought after balance of production and distribution investments. Only then, can the transactors consider the ensuing joint value in a tradeoff with governance costs to maximize transaction value.

Provided this reverse relationship can be established and explained within the TCE framework, the theory will not only be a powerful guide for understanding and choosing vertical structures, but also a more important strategic management tool guiding industry practitioners towards maximizing transaction value. Understanding the effects of structure on specific investments represents the first required step in pursuing a fuller transaction value analysis as proposed in the model above. Hence, elaborating on TCE theory to better understand and explain this reverse relationship between structure and specific investments becomes the express objective of this study.
3.6 Research Question: How Structure Affects Specific Investments

The objective of this study as set out above is pursued by utilizing the rich context of contracting and investments by and between producers and distributors in the motion picture industry, in which transaction-specific investments are treated as the dependent variable in relation to structure. It follows from the proposed transaction value model that I do not start with a blank canvas looking for any variables explaining how transaction-specific investments come about. Instead, I concentrate on a narrower scope seeking to enhance: (a) the understanding of how structure affects specific investments, and thus also (b) the understanding of the interdependent relationship between structure and transaction-specific investments.

Following from this approach, the main research question is:

*How do different types of contractual production-distribution structures utilized in the motion picture industry affect the transactors’ production and distribution investments in a feature film project?*

The contractual production-distribution structures refer to the contracting used to govern transactions between producers and distributors (between the production and distribution functions), and the production and distribution investments represent the transactors’ cooperative specific investments into the joint product. On a more generalized or theoretical level, this research question asks how governance structure may affect the transaction parties’ specific investments.

While the “how” question could be interpreted to simply establishing correlations, the aim of this study is to establish a deeper understanding of the processes involved. Given the amount of empirical research carried out on the effects that specific investments have on governance structure, establishing correlations is less interesting than understanding exactly how the reverse relationship works. That means understanding the contracting and investment processes, how these processes play out and the sequence of the actions involved. Being able to answer the “how” question in such detail is what eventually will give the theory elaboration explanatory power. Consequently, one may also say that there is a “why” question embedded in the research question following from the research objective of theory
extension. The objective is not so much searching for generalities as searching for causes.

Seen in the context of established transaction cost theory, the research question indicates an interdependent relationship between structure and transaction specific investments. In Figure 3.3 below, which offers a more detailed view of the left-side relationships between structure and specific investments in Figure 3.2 above, the causal relationships established in the TCE literature are marked with dotted arrows, while the relationships subject to this study – representing the theory elaboration - are marked with solid arrows.

![Figure 3.3 - Research model. Core variables: Governance structure (vertical and horizontal) and transaction-specific investments.](image)

In Figure 3.3 above, a distinction is made between vertical and horizontal governance structure in the producer-distributor relationship. As discussed in Chapter 2 above, vertical integration and vertical interorganizational relationships have dominated transaction cost research, but there have also been a number of studies on horizontal interorganizational relationships. While maybe less obvious than vertical relationships in the context of production-distribution contracting, horizontal relationships represent a
dimension of contracting structure that should not be ignored in this study. However, rather than adding a horizontal perspective by looking at the relationships between functions at the same horizontal level in the value chain, as for example studying co-marketing efforts between distributors of the same feature film, the horizontal perspective is added to the vertical production-distribution transaction. A horizontal perspective is therefore added to the core transaction being studied (Figure 3.4A) rather than to relationships between functions or entities at the same level in the value chain (Figure 3.4B). The horizontal variation in the production-distribution transaction is created because a producer, for one specific movie may contract with one distributor (known in the industry as an all rights deal) or two or more distributors (e.g. one domestic and one international as illustrated in Figure 3.4A) (a split rights deal). Thus, this treatment of the horizontal transaction dimension is more similar to Bradach and Eccles’ (1989) “plural forms” approach, in which the focus is expanded from a single governance form to a combination of governance forms. This approach focuses on organizations that apply two different structures with different strengths and weaknesses, such as company and franchise arrangements, so that each can be used to leverage the strengths and ameliorate the weaknesses of the other. While similar in certain ways to the plural forms approach, the horizontal treatment here is somewhat simpler, primarily focusing on the level of horizontal integration, i.e. the involvement of one versus two or more distributors.

Figures 3.4A - Horizontal dimension of P-D transaction, and 3.4B - Horizontal D-D relationships
The study hence investigates both the vertical and horizontal dimension of the production-distribution transaction:

1) Vertical: The relationship (marked A in Figure 3.3) between the degree of vertical integration in the production-distribution dyad (the vertical P-D structure) and the level of transaction-specific investments made in the joint product; and

2) Horizontal: The relationship (marked B in Figure 3.3) between the integration of the distribution functions (the horizontal P-D structure) and the level of transaction-specific investments made in the joint product.

Finally, seeking a deeper understanding of the contracting and investment processes, one may expect to find some key intermediate variables that help explain the causal links between structure and transaction-specific distribution investments. An important contribution of the study would therefore be to identify intermediate variables (marked "i" in Figure 3.3 above) and explain the causal links between these and the core variables, structure and transaction-specific investments. These “new” variables are therefore not brought in as alternative independent variables to structure explaining transaction specific investments but as dependent variables to structure that subsequently act as independent variables in relation to transaction-specific investments. Identifying and explaining the causal relationship between these intermediate variables and our core variables is similar to the process of identifying the intervening causal process between two variables, which have been termed by some as process tracing (Welch, Piekkari, Plakoyiannaki, & Paavilainen-Mantymaki, 2011).
4 Study Outline and Methodology

This chapter will elaborate on methodological issues encountered in pursuing the research objective and answering the research question set out in the previous chapter. It first discusses the choice of a qualitative approach, then the case study research strategy and design and the methods of data collection and analysis utilized, before finally making a note on the chosen approach to theory building.

4.1 A Qualitative Approach

It follows from the research objective and research questions that theory building is the key feature of this study, and while a number of quantitative research methods have excellent qualities for theory testing, qualitative approaches are often better suited for theory building purposes since they offer a better context for answering the “why” questions, in addition to the “what” and “how” questions that in many instances can also be addressed with quantitative methods (Andersen, 1997; Yin, 2009). The “what” questions determine which factors are considered as part of the explanation of the phenomena, whereas the “how” questions determine how these factors are related. Taken together, these elements constitute the domain or subject of the theory. However, it is the “why” questions that specify the economic dynamics that justify the selection of factors and the proposed causal relationship. This rationale constitutes the theory’s assumptions – the theoretical glue that welds the model together (Whetten, 1989). Indeed, some of the seminal TCE developments have been based on qualitative approaches, including Coase (1937) and Klein, Crawford and Alchian (1978).

Here the “whats” are the key phenomena, structure/contracting and transaction-specific investments, as well as the intermediate variables or phenomena identified through the data collection and analysis. It is noted in the previous section that the “how” question asked here goes beyond a simple correlation type understanding of how specific investments are related to structure; it seeks a deeper understanding of causes and consequences. This is more in line with Eriksson and Kovalainen’s (2008) broader approach to “how” questions being suited for qualitative methods in business research, in which the aim is to shape understandings of how something takes place, works or interacts. This incorporates the economic
dynamics, typically associated with “why” questions, in addition to determining how the factors or phenomena are related; hence, this type of “how” is not strictly distinguished and separated from “why” but also involves a “why” in a broader and more profound use of the “how” question.

To develop this type of understanding of how structure affects transaction-specific investments also necessarily demands a thorough understanding of these phenomena themselves as they appear in the given context. It is not sufficient to learn that a producer and distributor use this or that kind of contracting and make what type of investments, we also need to understand how the contracting, investments and the transactions actually take place. We need to understand the dynamics, including for instance how and when the investment decisions occur. Silverman (2006) notes that “(t)he main strength of qualitative research is its ability to study phenomena which are simply unavailable elsewhere. Quantitative researchers are rightly concerned to establish correlations between variables. However, while their approach can tell us a lot about inputs and outputs to some phenomenon (…), it has to be satisfied with a purely ‘operational’ definition of the phenomenon and does not have the resources to describe how that phenomenon is locally constituted” (p. 43). As will be developed further later in this chapter, the qualitative approach was chosen precisely because it offers the best possibilities for developing a deeper understanding of how contracting and transaction-specific investments play out in the transactions between motion picture producers and distributors.

Before moving on to the specifics of the chosen qualitative approach, it is interesting to contemplate the possibilities and implications of a quantitative alternative. The choice between quantitative methods and a qualitative approach is sometimes attributed to a choice between studying a few issues in many observations or many issues in a few observations (Larsson, 1993). Since the theory development element of this study is rooted in the existing framework of TCE theory in which key variables are given, it would be possible to limit the variables (phenomena) to these key variables, thus abandoning the search for intermediate variables and choosing a quantitative approach that focuses on governance structure and transaction-specific investments. As we shall see, it is possible to categorize the most frequently used forms of production-distribution contracting into relatively broad idealized categories of contracts and then relate these to Williamson’s (1991) generic forms of governance structure. Therefore, at least in principle, this
opens up the possibility of carrying out a study similar to this one as a quantitative survey. But many problems remain, some related to theory building and some of a more pragmatic nature. First, an exploratory quantitative survey may indicate how (in a correlation type of way) distribution investments are affected by structure, but such studies are seldom able to give any strong indications on why (Yin, 2009), which is important in a theory development process like this one. Answering the how questions would give us an indication of the correlation between the key variables, but since the main purpose of this study is to determine the causal relationship in the direction from governance structure to specific investments, simply establishing correlation would be, as discussed above, unsatisfactory. And again, since the reverse relationship between specific investments and governance structure is well established in transaction cost literature, the correlation between these key variables is to a large extent given, and establishing such a correlation would not produce any significant new knowledge unless the findings would contradict established transaction cost theory.

Second, on a pragmatic level, even if the broad contracting categories are helpful in effectively relating the most common production-distribution contracts to Williamson’s generic forms of governance structure and corresponding contract law, it remains a considerable analytical job to fit real production-distribution contracting into the idealized categories. Unless one can rely on secondary data, in which contracts are already categorized in a way relevant to this study, or on substantial resources to carry out the categorization oneself, one would risk ending up with a very low N for any such survey. To the best of my knowledge, no sufficient categorized data is available and prior to this study the categories were also underdeveloped in relation to TCE theory. Further complicating a survey approach is the availability of primary un categorized data. A preliminary round of interviews that I carried out among US producers, distributors and entertainment lawyers, as well as scholars doing research on the motion picture industry, at an early stage in this research project indicated that production-distribution agreements typically are kept confidential and a researcher aiming to do a survey is therefore likely to encounter major difficulties in obtaining access to a sufficient number of recent documents. Furthermore, even in what seems like the unlikely case that one would gain access to a sufficient number of contracts, particularly sensitive information
– including the specific amounts invested – would most likely be blanked out, hence creating difficulties in establishing the other key variable.

Relaxing the contemporary requirement, one may gain access to written contracts that are parts of significantly older archives donated to research institutions by production or distribution companies or otherwise made available to academics, but even these may be restricted by certain confidentiality clauses. The Warner Bros. Archives at the University of Southern California (USC) was identified as one possible source for such historic documents. It was donated to USC in 1977 by Warner Communications and contains documents from 1918 to 1968, including legal files for Warner feature films (USC, 2011). However, these files may not hold sufficient information for each feature film project to determine contracting structure and investment levels split between production and distribution, not to mention that the variance in contracting structure has changed and significantly intensified since this historic period (Putnam & Watson, 1997).

As a result, there would be significant pragmatic hurdles to carrying out a quantitative survey. Since the economic case for qualitative studies is strongest where the required information is not readily available in aggregate data or in good secondary sources and is intrinsically hard to get (Eckstein, 1975), this also suggests a qualitative approach as containing the most efficient methods for the research objectives raised here. But, even if these pragmatic issues could be overcome, the critical argument against a quantitative approach for this study remains that it would not provide the ability to study the key phenomena with the microanalytic detail necessary for the sought theory development.

4.2 The Case Study

Qualitative research is not one neatly defined and contained methodological approach, but instead covers a wide range of different and even conflicting activities (Creswell, 2007; Eriksson & Kovalainen, 2008; Silverman, 2006). Among the most common approaches are ethnographic research (reports shared patterns of behavior, beliefs and language for a cultural group), narrative research (reports the life and experience of a single individual with a focus on the sequence of events to generate meaning), phenomenological research (reports on the lived experience of a concept or phenomenon for
several individuals), grounded theory research (applies a number of systematic procedures to move beyond description generating or discovering middle-range theory, as opposed to broad, macro-level theory), action research (researcher actively engages and collaborates with the research object and its practical problem solving to generate knowledge) and case study research (reports on an issue or issues explored through one or more cases within a bounded system). Among these approaches, the qualitative case study was deemed best suited for this study for the reasons specified in the following pages.

Case studies are often associated with the use of qualitative data and ethnographic data collection methods (observation and interviews). However, as with some of the other approaches listed above the case study approach does not imply the use of any particular type of evidence nor the use of a particular data collection method. The case study approach represents a research strategy, and as such, the distinguishing characteristic of the case study is that it attempts to examine: (a) a contemporary phenomenon in its real-life context, especially when (b) the boundaries between phenomenon and context are not evident (as it is for example with experiments) (Yin, 1981). In this study, the contemporary phenomenon is the link between contracting and specific investments, and the context is the motion picture industry. And it is not evident at the outset where the boundaries between our relationship of interest and the industry are drawn. If such boundaries were clear, the search for intermediate variables or phenomena would be redundant. But before these are identified through data collection and analysis, it is not possible to say which phenomena occurring in the industry are integral to the understanding of the contracting - specific investment relationship and which are not.

A case study’s focus is on understanding the dynamics present within single settings, and it therefore typically involves in-depth studies of one or a few cases in which the unit of analysis is seen as a complex entity where subunits and their relationship to each other are subject to extensive analysis (Andersen, 1997; Eisenhardt, 1989b). Such qualities are easily recognized in relatively early groundbreaking case studies like Allison’s (1971) study of the Cuban missile crisis, Lysgaard’s (1961) study of labor sociology in The Workers’ Collective and Whyte’s (1955) study of community sociology in Street Corner Society. The equivalent for the present study would be to apply a less prestructured approach as for instance with an objective of
simply seeking a better understanding of specific investments in the motion picture industry. However, as we shall see, this study’s highly prestructured approach differs from these classic case studies in terms of intensity and the number of cases.

The number of cases is used by Yin (2009) as a primary classification of case studies into those that involve a single case and those that involve multiple cases (single-case design vs. multiple-case design). The single-case design is often associated with “classic” case studies, including those mentioned above, in which the researcher engages in the most in-depth and detailed study of a single case that resources allow (Dyer & Wilkins, 1991), while the multi-case design is sometimes seen as a hybrid form of case research with more of an emphasis on developing clear constructs and testable propositions (Eisenhardt, 1989b). This classification is similar to Eriksson and Kovalainen’s (2008) distinction between intensive and extensive case studies. An intensive case study defines one (or few) unit(s) or individual(s) as “case(s)” and its objective is to learn how this specific or unique case works. This is done through contextualized and “thick descriptions” of the case. A thick description is one that analyzes the multiple levels of meaning and is able to crystallize the reasons behind the multifaceted details of the case (Eriksson & Kovalainen, 2008; Silverman, 2006). On the other hand, an extensive case study is one that focuses on a phenomenon that may be studied by using several units or individuals as instruments in the study. The emphasis is therefore not on the cases (units or individuals) as intrinsically interesting in themselves, but on the phenomenon or phenomena studied through the cases. The objective is often – as with this study – to elaborate on gaps in existing theory. Compared to the intensive case study the description is typically “thinner”, sparsely described and more abstract in nature since the cases are not studied in every detail, but according to the researcher’s predefined research interest. Finally, it should be noted that a strict distinction between single and multiple case designs may be difficult to draw. As shown by Eisenhardt (1991), even classic case studies generally considered of single-case design apply many of the analytical methods associated with multiple-case design studies. For instance, in the Street Corner Society, Whyte studies multiple gangs in a single setting, Boston’s North End. The single setting has classified it as a single-case study, but many of the observations are repeated across gangs, leading to generalizations similar to a multi-case design approach.
The prestructured approach and theory elaboration objective following from the theoretical framework set out in Chapter 3 clearly place this case study in the extensive category. Our focus is on the key phenomena of contracting and specific investment and on the link between these, and not on the specific cases in themselves. The study also has what Yin would classify as a multiple-case design, which will be evident from the case definitions following the unit of analysis definitions below. The key motivation for the multiple-case design is to obtain variance in our independent variable (contracting forms) to see if and how different forms of contracting vary in their impact on specific investments.

4.3 Unit of Analysis

The study’s unit of analysis largely follows from the research question and its origin in TCE theory. Transaction cost economics is based on Commons’ concept of the transaction being the basic unit of analysis in economic research rather than the firm (Commons, 1924, 1934). This study is concerned with the transaction between the producer and distributor of a movie (that is the transaction between production transactions on the one hand and distribution transactions on the other), and how the governance structure for such a transaction affects the parties’ specific investment. It is thus concerned with the production-distribution transaction, and this transaction is defined as the study’s unit of analysis.

However, as we have seen (Figures 3.4A and 3.4B), the production-distribution transaction for a movie may consist of more than two parties and a set of related transactions rather than a single discrete transaction, and the transactions involved may be categorized along a vertical and horizontal dimension. Yin (1994) classifies case studies into those that have a single unit of analysis (holistic case studies) and those that have multiple units of analysis within a single study (embedded case studies). Since our unit of analysis may be divided into vertical and horizontal dimensions, these dimensions are considered subunits. With the two subunits of the vertical production-distribution transaction and the horizontal dimension of the production-distribution transaction, the study may best be categorized as embedded in following Yin’s classification.
4.4 Selection and Definition of the Cases

Case definitions follow from how the unit of analysis is defined (Yin, 2009). Our case or cases will therefore be one or more production-distribution transactions, and this particular type of transaction represents the study’s initial population. Even so, thousands of movies are produced every year involving some form of contracting between producer and distributor, and these movies range from large “blockbusters” like Avatar and Pirates of the Caribbean to smaller student projects. This study will only look at production-distribution contracting for theatrical feature films, meaning movies longer than 80 minutes in running time that are given a general cinema release. The marketing and release of a theatrical movie is quite different from the marketing and release of a home video or television movie (a movie that is not given a theatrical run but released directly to home video or television), and mixing categories of theatrical, home video and television-movies is likely to create a significant disturbance from contextual variables. Furthermore, theatrical feature films are per definition the category that is released in most media and markets since they are released theatrically as well as in home video and television markets. It is therefore more likely that they are handled by different distributors, and production-distribution contracting for theatrical movies therefore best serves to study the impact of split distribution functions or the level of horizontal integration on cooperative-specific investments.

It could be interesting in itself to study production-distribution relationships in different markets around the world since coherent findings with regard to our key variables would create powerful results due to a strong variance in contextual variables. However, the study limits itself to look at the contracting for American theatrical movies (so-called Hollywood movies). This is done because the variance in contextual variables could easily turn out to be so strong that it would be difficult to subscribe any variance in our dependent variable to the independent variables we are interested in studying, even using a qualitative approach. While the American film industry probably has the most “industrial” organization of the world’s national motion picture industries, many European countries operate a quite different system settled more deeply into the cultural sphere where the motion picture sector is heavily dependent and thus controlled by public or state incentives (Dale, 1997; Putnam & Watson, 1997). To give an example: As to the question of why producers and distributors contract before the
commencement of production regardless of contracting form, a Norwegian producer or distributor would most likely answer that it is done because it is a requirement of the Norwegian Film Institute (Gaustad, 2009). With state regulations and support systems varying from country to country, it is likely that such strong contextual differences would make direct comparisons between data from different countries very difficult. Avoiding these kinds of regulatory biases is also important, as the transaction cost theory relies on the efficiency of *competition* to perform a sorting between more and less efficient governance structures and to shift resources in favor of the former (Williamson, 1985).

However, if the resources were available, one could certainly gain from carrying out parallel studies in different countries to see whether theoretical propositions gaining support in one context also did so in others. This would be in line with a “most different systems” research design (Andersen, 1997), and a follow-up study of this nature would greatly enhance our finding’s external validity. But since the focus here is on theory development, advancing the understanding of the theoretical questions of *what, how* and *why* needs to take center stage. When these core elements of theory are in place, work involving parallel studies in different environments would be a natural second step to look more deeply into the questions of *who, where* and *when*, which would define temporal and contextual boundaries of the developed theory. Finally, carrying out parallel studies – each with the depth necessary for theory development purposes – would not have been possible with the limited resources available for this study.

To control for extraneous/environmental variation, the initial population of motion picture industry production-distribution transactions is narrowed down to production-distribution transactions for American theatrical motion pictures, which also helps in defining the limits for generalizing the findings (Eisenhardt, 1989b). Limiting extraneous variation by narrowing the initial population also means that the choice of cases will reflect a “most similar system” research strategy (Andersen, 1997) in which cases are chosen to obtain variance in key variables, while limiting as much variance as possible otherwise.

For extensive case studies or multiple-cases designs like this study, cases are chosen and defined according to theoretical, not statistical, criteria (Eisenhardt, 1989b; Eriksson & Kovalainen, 2008; Yin, 1994). Our key
variables are transaction-specific distribution investments and governance structure or contracting form, and a comparative case study will therefore be used to investigate the incentives and conditions for transaction-specific distribution investments under the different contracting forms used in the American motion picture industry. For the vertical dimension of governance structure, which based on our theoretical framework represents our primary interest for the independent variable, two cases were chosen and defined to reflect relatively polar points on a scale from pure market to pure hierarchy. As Eisenhardt (1989b) notes, with the objective of building theory it makes sense to select polar types of cases since the process then becomes more “transparently observable.” Choosing polar type cases excludes a specific treatment of the hybrid form, but for the purpose of theory development the key issue is to obtain unambiguous variance in the degree of integration, not to define cases that fit one-to-one with Williamson’s three categories of market, hybrid and hierarchy. The vertical governance structure cases studied here are therefore:

1. Acquisition contracting

2. Output contracting

While these cases respectively represent relatively non-integrated and integrated governance structures, they do not equal Williamson's polar categories of market and hierarchy. Acquisition contracting does for instance not necessarily fit with the faceless nature of pure market transactions and the output contracting involve contracting between two separate business entities, not within the hierarchy of internal organization. Generally, both forms are located somewhat in a hybrid direction from the theoretical polar forms of market and hierarchy. Within both categories of contracting, there is some variation among the standard contracting forms (Baumgarten, Farber, & Fleicher, 1992; Variety.com, 2002) and sub-categories are thus defined in the following chapters. It may be argued that the least integrated sub-category of output contracting is as close to a theoretical hybrid form as to hierarchy, and that the most integrated sub-category of acquisition contracting is as close to a hybrid form as to market. Yet, both acquisition and output contracting represents standard forms of contracting in this industry that correspond to distinctively different levels on the market-hierarchy scale (as illustrated in Figure 4.1 below), and the relative
difference between them will therefore offer the theoretically sought after variation with regard to vertical governance structure.

![Figure 4.1 - Acquisition and output contracting on a scale from market to hierarchy](image)

To address the subunits and study the relationship between horizontal contracting forms and transaction-specific distribution investments we will look at two forms of contracting that in a similar way represent relatively polar forms, but on a horizontal scale:

A. Split rights deals

B. All rights deals

All rights deals refer to those producer-distributor relations in which all distribution rights are handled by one distributor that may or may not sublicense some rights to other distributors. Split rights deals refer to all producer-distributor relationships in which the distribution rights are split between two or more distributors directly from the producer’s hand (Cones, 1992).

We hence have two transaction cases defined by their degree of vertical integration, each with two embedded cases defined according to horizontal integration, as illustrated in Table 4.1 below. The less integrated contracting is found in the upper left square (1A) and the most integrated in the bottom right (2B).

<table>
<thead>
<tr>
<th></th>
<th>Acquisition</th>
<th>Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Split rights deals</td>
<td>1A</td>
<td>2A</td>
</tr>
<tr>
<td>All rights deals</td>
<td>1B</td>
<td>2B</td>
</tr>
</tbody>
</table>

*Table 4.1 - Cases and embedded cases*

To a certain extent, these four cases all represent constructs of standard contracting forms between producers and distributors in the motion picture
industry rather than a sample of actual "real life" contracts directly observed in a sample of specific transactions. The empirical world, and indeed real production-distribution contracting, is limitless in its detail, complexity, specificity and uniqueness, which raises the potential problem of finding the clear boundaries of a case. However, the four construct categories defining our cases refer to conventional units used in the motion picture industry, which greatly simplifies delimiting the cases. Using for example the empirically non-conventional vertical categories of market and hierarchy rather than acquisition and output contracting would have severely complicated the relationship between theory and data since it would have been difficult to define the boundaries of such cases in the empirical world. The conventional categories chosen highlight certain features of the empirical contracting that fit into each category and washes such empirical units of their specificity. Ragin (1992) argues that defining cases, which he refers to as "casing," is a research method bringing operational closure to problematic relationships between ideas and evidence, between theory and data. The cases defined here do indeed bring such operational closure to the relationship between theoretical ideas about governance structures and empirical evidence for the motion picture industry.

Pragmatic considerations also favored working with contracting categories as cases rather than the alternative, which would have been a sample of specific transactions (movie projects) to fit units and subunits as specified in Table 4.1. Already in the preliminary round of interviews, it became clear that obtaining the sought after amount and detail of information for any specific movie project would prove to be a challenge. Questions regarding production-distribution contracting and investments are sensitive since they eventually also become important for how project earnings and revenues are split and distributed - the value claiming part of the joint value approach. It is not unusual that cases with both substantial losses and earnings end with disputes and court procedures (Cones, 1997), so for this reason both producers and distributors tend to be extremely careful not to disclose – in document, interview or any other form – any kind of information that may be sensitive and unfavorable in any such dispute. Given these stakes, promises of anonymity for both case and interviewee are not sufficient to rest these concerns since each movie project is unique to a certain degree and may therefore still be identified even if sought to be anonymized. Publicly available documentation for specific projects is also limited. At best, trade
journal articles cover only one or few aspects of interest sufficiently for any given film project. There are some monographs written about certain movie projects that yield rich insight into key issues of contracting, organization and investment decisions, such as Bach’s (1985) detailed account of the production and distribution of Heaven’s Gate, a project that eventually caused United Artists (at the time one of the major studios) to go bankrupt, but these are few and finding at least four that covered reasonable recent projects, with each representing a subunit of analysis, was not possible.

If specific projects could have been used as cases, this would have had a clear fit with the notion that extensive case studies are interested in certain phenomena found in the cases - the contracting used and investments made for the specific project. Having defined the cases as specific categories of contracting, it may be argued that a key phenomenon is itself used as case, blurring the distinction between phenomenon and case. From this perspective, one may say that this study utilizes a somewhat fringe case definition. Nonetheless, the chosen approach gives access to a better quality and depth of data, and the case structure provides an economic and fruitful framework for analysis, thus giving operational closure to the relationship between data and theory.

Additionally, a note should be made about Eisenhardt’s (1989b) recommendation to use at least four cases when aiming to build theory. The argument here being that it may be difficult to generate theory with much complexity when using fewer cases; the empirical grounding of the theory may then also be less convincing. However, each of the vertical cases used here are divided into sub-cases, thereby providing more detail and variation, and furthermore as will be discussed in more detail below, each of the cases contains a large number of “mini-cases” within it in the form of specific production-distribution transactions fitting the category, which are made reference to in the various data sources. As Eisenhardt acknowledges, in these instances a lower number of cases will still produce rich data that does not limit either theory complexity or sound grounding. Eisenhardt (1991) also notes that debating the number of cases may obscure the essential point of how much new information is likely to be learned from incremental cases. For this study, it was considered more efficient allocating the research resources obtaining a deeper understanding of each of the two identified cases, than to add another case (contracting category) on the continuum from market to hierarchy.
Finally, it is important to note that the research question asks about the relationship between structure and specific investments concerning a feature film project or, in other words, how the production-distribution contracting used for a specific movie project affects the transaction parties’ investments in specific assets supporting the transaction for that particular movie. A transaction may be a slippery unit of analysis, thus a precise definition is important. Here, choosing the perspective of a singular transaction for a project instead of plural transactions has fundamental implications for the definition and understanding of key transaction dimensions. When looking at the production and distribution of a single movie, the transaction output is not the copyright and master copy of the movie, but the movie performances and copies (the cinema screenings, the DVD-copies, the TV broadcasts, etc., see also Table 1.1). The copyright and master copy, as well as the awareness about the movie created by marketing efforts, does in fact represent specific assets supporting the transaction, and investments into these assets are therefore transaction specific investments. This may be compared to a pharmaceutical company’s investments into research and development for an approved and patented first copy of a specific new drug and subsequently into the marketing of this drug, and how these investments may be seen as transaction specific from the perspective of the transactions concerning this particular drug. It follows from this project-oriented thinking that the transaction frequency is best described in terms of the number of copies or performances sold (and in the pharmaceutical example, the sales volume of that specific new drug). For a successful movie this will be a very high number of small transactions, but as sales will always be unknown until the movie is released (De Vany & Walls, 1999), implications include a significant uncertainty about the frequency at the time the investment decisions are made. Keeping in mind that the key relevance of frequency for asset specificity is that specific investments are easier to recover for large and frequent transactions, which ultimately means that one should expect these transaction-specific investments to be associated with a significant level of risk. If, instead, taking the perspective of plural production-distribution transactions, the output would be the master copies or movie projects. Production-specific assets would be of the kind that support the manufacturing of movies such as sound stages and specialized equipment (cameras, lighting, low-riders, etc.), and distribution-specific assets of the kind that support the licensing and marketing of movies such as human asset specificity (skilled licensing and marketing personnel), although none of
these would necessarily be specific to the production-distribution transaction. For instance, if the transaction was a quite typical output deal covering a slate of 10 movies to be produced over five years, transaction-specific investments within this perspective would be limited to the contracting (ex ante) and governance structures overseeing the transaction (which may have included dedicated personnel at both the producer and distributor). Neither these nor the production- and distribution-specific assets are specific assets from the project-oriented perspective, as they could be redeployed from one project to another without any value lost. Within the plural perspective, frequency would relate to the number of movies a producer and distributor dyad transacts, and uncertainty would not be related directly to the market uncertainty of each specific movie. Still, the plural perspective may of course inform the project-oriented view. For example, the transaction frequency of a particular producer-distributor dyad would be likely to also have implications when a project perspective is taken on one of the movies, but yet clearly choosing and specifying the perspective of a feature film project has obvious important implications for the reading of case analyses and the conclusions drawn.

The case descriptions provided for the chosen contracting categories in this section are cursory and only for the purpose of explaining research design and methods, though of course the cases are thoroughly described in the following chapters.

4.5 Data Collection

Caves (2000) has noted that the organization of the creative industries, including the motion picture industry, has received surprisingly little attention from economists, and he argues that one of the main reasons is that “economists, proud of their theoretical apparatus and facility with statistical tools, are put off from industries such as these that yield few congenial data sets”. But he also observes that “[…] while systematic data is scarce, copious information on deals and trade practices is available in trade journals and general newspapers, as well as in books by nontechnical observers of these activities. If one settles for information that is heterogeneous and largely qualitative, but nonetheless abundant, a great deal can be learned of the economic organization and the behavior of these sectors” (p. vii).
In line with Cave’s observations and the discussion of the qualitative approach above, the data collection for my cases relied on a number of sources of evidence within two main categories: documentation and interviews.

4.5.1 Documentation

All documentation or textual data used were preexisting texts, i.e. secondary data and publicly available requiring no specific consent for use. As such the use of this data contributes to greater transparency (Eriksson & Kovalainen, 2008). The primary categories of sources are trade journal articles, sample contracts and monographs.

Trade journal articles represent a significant and easily accessible source of documentation, as they report on a wide range of business issues within the industry on a daily or weekly basis. The leading trade journal for the North American motion picture industry is Variety (daily, weekly and variety.com), followed by its competitor The Hollywood Reporter (electronic daily, printed weekly, special reports and hollywoodreporter.com). Of these, Variety was used as the primary trade journal for this study, but supplemented by articles from The Hollywood Reporter. In addition to the trade journals, some newspaper articles were also used, primarily from The Los Angeles Times. With the main cluster of the North American motion picture industry located within the greater Los Angeles area, hence representing one of its main industries, the Los Angeles Times has a dedicated part of its business section to covering the industry (the “Company Town” section) and in addition to shorter news articles, it frequently runs feature length articles on specific industry topics or cases.

In a manner similar to how cases were selected by theory-driven, and not statistical criteria, articles were also searched for and identified based on themes or key words that appeared to be interesting based on the theoretical framework. Articles concerning contracting or deals between producers and distributors were sought out at an early stage since this theme follows directly from the research question. These articles then revealed other themes that were thought to be interesting, and the analysis of these again would lead to new themes and searches. Similarly, when one particularly interesting transaction was identified, further searches were made for more articles that covered this transaction. This was the basic thematic snowballing selection strategy used. The first batch of articles were found at
the Academy of Motion Picture Arts and Sciences’ Margaret Herric Library in Beverly Hills, which keeps a by now old fashioned but very useful archive of newspaper and trade journal clippings sorted by topics, themes and names. Further searches were made electronically with the added advantage of getting the articles in an electronic format, which greatly simplified the analytical process.

Sample and standard written agreements were found for acquisition types of contracting only, suggesting that these types of transactions are more standardized and represent a higher volume of transactions than output contracting. Sample acquisition agreements were found in both relatively inexpensive sample contract collections aimed primarily towards independent producers (Litwak, 1998), as well as in the high priced collections, available at the Margaret Herric Library, aimed primarily towards legal professionals, which also includes more detailed comments and notes to specific contract clauses (Farber, 2001a). These sources also contained other contracts that through the data analysis also turned out to be of relevance.

North American written agreements are generally extensive in form, and contain a wealth of information about the transactions they govern. The sample contracts therefore represented an important tool in setting some of the key parameters for the different contracting forms, and they sometimes also gave indications as to the relationship between contracting form and investments.

The final documentation source category is monographs written about the North American motion picture industry. These typically tell the story behind a specific film project or an industry personality. While none were identified that specifically dealt with contracting and investments, many contained bits and pieces of information on relevant topics, including contracting, financing, distribution and marketing.

4.5.2 Interviews
While interviews are sometimes considered a taken-for-granted method within qualitative business research, Eriksson and Kovalainen (2008) urge a careful consideration of the often underestimated difficulties of doing good interviews, and even more so of analyzing them well. However, for this study interviews were considered both necessary and valuable since they
offered the only viable method of directing a deeper inquiry into specific topics and issues of interest. The preexisting documentation only offered the data that was already produced, leaving little opportunity for digging deeper into particular issues or cases beyond searching for more preexisting documentation. Through the interviews, however, it was possible to ask follow up questions, requesting the interviewees to elaborate, suggest topics they felt would be relevant to the context of the study and so forth. With many, it was also possible to return at later stages in the project with follow-up questions.

The key criteria for selecting interviewees were that professionals from both sides of the transactions (producers and distributors) needed to be included and they should be experienced - ideally decision makers in relation to both contracting and investments and with experience from all different types of transactions covering the embedded cases. The first criterion obviously follows from studying transactions, but is also linked to dealing with the challenge of bias. To avoid the criticism that theory built from interview data is really just retrospective sensemaking by image-conscious informants, the use of informants that view the focal phenomenon from diverse perspectives is useful as it is unlikely that these people will engage in convergent retrospective sensemaking and/or impression management (Eisenhardt & Graebner, 2007). The remaining criteria specify desired knowledge and experience, particularly in relation to making strategic decisions.

Particularly at the beginning of the process, one sometimes fell into a quantitative thinking trap, worrying about the number of interviews, equal representation for different categories of players, etc. Such thinking would easily cause stress as Hollywood executives are not particularly accessible, and gaining access to interviewees required systematic and relentless work. However, for a qualitative study of this nature it is essential to maintain focus on the quality rather than the quantity of the data. One well conducted interview with a single well placed and knowledgeable interviewee with decision-making experience is likely to produce data more valuable than 20 interviews with more marginal, less knowledgeable industry professionals without decision-making experience. Hence, the focus soon turned to acquiring access to a shorter list of “most desired” interviewees and then preparing carefully for each of these interviews to get the most out of each of them.
Anonymity was offered to all interviewees. Arguments may be made against anonymity, including that non-anonymous case studies can be reviewed more readily than anonymous studies (Yin, 1994), but anonymity was deemed necessary to protect the participants, giving them more comfort to speak openly about the issues. While the cases discussed were categories of contracting and not specific production-distribution transactions all interviewees made references to particular projects during the interviews as examples of various points made. Without anonymity, it is reasonable to believe that they would have been more reluctant to offer such details.

Based on the above criteria, 68 industry professionals were identified and approached with a written request to be interviewed. The request included a short presentation of the project, information about anonymity, the estimated time required for the interview and a timeframe within which I would be in Los Angeles to conduct the interviews. Important tools and sources in the identification process included industry directories, references made in trade journal articles and recommendations based on the initial round of informal interviews with Los Angeles-based researchers, entertainment attorneys and industry professionals. The opportunity to use snowballing (in which one interviewee recommends others) was restricted since my stay in Los Angeles was limited. Typical challenges faced in obtaining interviews included the industry professionals’ tight schedules and general unavailability, but a hesitation to participate based on the perceived sensitivity of the topics was also encountered. The example of a production executive at one of the major studios is illustrative of the latter: After receiving the request and me making follow-up calls with the assistant, the executive contacts me via telephone, expresses interest in the project and makes further inquiries about anonymity, upon which he is offered a formal contract. He promises to get back to me within one to three days and does so, but with a pass on the interview. In one sense, the identification of a challenge like this one represents a finding in itself, and was included when analyzing the obtained data.

Despite such challenges, interviews with 10 of these well placed industry executives, all with extensive and relevant decision-making experience, were obtained. Six of these were producers or production company executives, while four were distribution company executives.
Table 4.2 - Production side interviewees

The production side interviewees are listed with names (alias), position and production company type in Table 4.2 above. Following case definitions production companies are split in two types, which are dependent on the dominant type of distribution contracting used at the time. Companies working primarily with acquisition type contracting are labeled Independent Production, whereas companies working primarily under output contracting are labeled Pact Production (since an output type contract is often referred to as a “pact” in the industry). Most interviewees had direct experience with a variety of distribution contracting forms. For example, James was currently operating without any output contracts, but had previously worked under output deals with one of the major studios. Some also had experience from the distribution side, having previously worked at major studios. Michael is a former Chairman and CEO for one of the major studios, and Ryan had more than 19 years of experience as an international marketing and distribution executive at another studio. None of the interviewees on the production side worked for the same company.

Table 4.3 - Distribution side interviewees

- **Alias**: Tom  
  - **Position**: COO  
  - **Company**: Major Studio

- **Alias**: Julia  
  - **Position**: Executive VP Worldwide Marketing  
  - **Company**: Mini-Major

- **Alias**: Emilie  
  - **Position**: President Domestic Marketing  
  - **Company**: Major Studio

- **Alias**: Jennifer  
  - **Position**: President Marketing  
  - **Company**: Major Studio Subsidiary
The distribution side interviewees are listed with names (alias), position and distribution company type in Table 4.3 above. All the distribution companies work with both acquisition and output types of contracting, but are distinguished according to type, primarily by size and scope. A Major Studio is one of the six big Hollywood-based distribution- and financing-driven integrated motion picture companies. A Mini-Major is a similar type of integrated distribution- and financing-driven company, but operating with less volume and scope, typically lacking some of the integrated resources of a Major Studio (such as an international distribution and marketing network). Some of the Major Studios also have separate subsidiaries dedicated to specific types of movies (typically for so-called arthouse and genre movies). One of the interviewees, Jennifer, was the head of marketing for such subsidiary. She works very much in the same way as her counterpart at the parent studio, but with responsibilities limited to a specific type of movie. One of the distribution side interviewees, Tom, also has a very strong production side background as the founder of a production company that grew into one of the leading Hollywood production companies. Tom has a particularly central role in the selection and financing of all movies handled by his studio. As COO he has the final word on which movies receive studio financing and which do not, which in practical terms translates to what movies are handled by the studio since the financing decision includes both production and distribution financing. Two of the distribution side interviewees worked for the same company.

The interviews were carried out at the interviewees’ offices and lasted from 45 minutes to two hours. They were all recorded, but during the interview with Brad the recording was cut off prematurely due to a flat battery, and extensive notes were made later the same day to compensate for the lost recording.

The approach to the interviews may be best described as semi-structured (Eriksson & Kovalainen, 2008). As is typical for these kinds of interviews, an interview guide was prepared prior to each interview with a list of topics.

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2 Paramount, Sony (Columbia/Tristar), Twentieth Century Fox, Universal, Walt Disney and Warner Bros.
3 E.g. Lionsgate, Summit Entertainment (recently merged with Lionsgate) and MGM (formerly a major studio)
and questions developed based on: 1) the research questions and (preliminary) analysis of other data collected up to that point, and 2) a review of the interviewee’s position and background, including specific projects and deals the interviewee had been involved in. The basic objectives of the guide was to cover issues which would provide material that would help answer the research question through analysis, as well as providing a framework within which the interviewees could express their understandings in their own terms. As suggested by Patton (1990), early questions would be about present activities and experiences, questions that encouraged the interviewee to talk descriptively. An example of this would be: *How do you work differently now with movies being acquired on a project-to-project basis than you did during your first-look deal with a Major Studio?* When a context is created through the response and further probing into these questions, other questions involving more interpretations and opinions would be asked. An example would be: *How and to what degree do you think the lack of formal integration through a first-look deal can be compensated for by informal integration through personal relationships?*

Most interviews were also carried out semi-structured in which topics were covered in a relatively systematic order, while the tone was kept conversational. Some interviews, however, turned out to more open as the interviewees would bring up important themes and topics not directly covered in the guide, but that typically followed from probing more deeply into some of the planned topics. The outlined topics were all still covered, but the interviews extended beyond these.

### 4.5.3 Data Triangulation

The opportunity to use multiple data collection methods and different sources of evidence is a major strength of case studies (Eisenhardt, 1989b), and it was particularly useful to this study since the cases consisted of construct categories in which the construct validity may more easily be questioned than when pure data categories are used. The understanding of “output contracting” is naturally open to wider interpretation than the understanding of “Universal’s first-look deal with Playtone”. However, with numerous sources, converging lines of evidence can be created through data triangulation (Patton, 1990; Yin, 1994). Different data sources reveal different aspects of the phenomena, and evidence from one category may corroborate information from other sources. For instance, data from some distribution side interviews revealed other aspects of output contracting than
data from some production side interviews, and the combination of these may corroborate with data from trade journal articles and monographs. This combination provides a more complete and nuanced understanding of the phenomenon and through the corroboration a cross-data validity check is created. Hence, the triangulation provides stronger substantiation of constructs, and as will be seen in the next section, also of hypotheses.

The potential importance of data triangulation for improving internal validity in case studies is reflected in the recent controversy (Coase, 2006) around the influential TCE case study of the relationship between General Motors and Fisher Body prior to the 1926 merger (Klein et al., 1978). Coase (2000, 2006) is not only casting doubt on the original authors’ interpretation of certain events as opportunistic behavior, but he also questions the authors’ representation of the facts.

4.6 Data Analysis

In an epistemological debate, this study would most likely be placed to the positivist side of the center on a continuum in which positivist and critical studies are found at each polar end with social constructivism placed around the center, just like the majority of studies building theory from cases would (Eisenhardt & Graebner, 2007; Welch et al., 2011). It is theory based, highly pre-structured, and sees contracting and investments in the motion picture industry as phenomena with various sub-phenomena to be understood and interpreted. On the critical side of the center, contracting and investments might instead be seen as socially constructed entities with social rules and patterned actions to be critically analyzed (Jarzabkowski, 2011). The implication for data analysis is that we are seeking facts, not only interpretations. Yet, the study should not be considered as purely positivistic either. Interview data and documentation are not considered as “truth mirrors,” but as biased data requiring an interpretation to be understood in context. One would expect that the information provided by producers Johnny and James on working under output contracting would differ since Johnny was working under his first output contract at the time of the interview, while James had lost his and was working with acquisition contracting. Similarly, one should not assume that documentation lacks bias (Yin, 1994). For instance, a sample acquisition contract found in a collection aimed primarily at producers is likely to be worded more favorably from a producer’s than a distributor’s point of view, and may therefore not give the
best picture of what fully negotiated and executed acquisition contracts look like. Both interview and documentation data thus demand interpretation. Finally, a purely positivist approach to data analysis combined with a subscription to TCE’s behavioral assumptions would also seem a somewhat odd couple. On the one hand, you would consider data obtained through interviews and documentation as facts, while on the other you would assume both cognitive constraints and opportunism. It seems more likely that the same producer who may disclose incomplete and distorted information while contracting may also do so during an interview about contracting.

In a strong interpretive social constructionist view, such incomplete and distorted information would be less of a concern (or of no concern) since the aim would be to understand how meaning is constructed rather than “truth-seeking” (Silverman, 2006), but in the more positivist approach taken when building theory from cases (Eisenhardt & Graebner, 2007) this kind of incomplete and distorted information represents a challenge of bias. Taking this approach, the challenges are partly mitigated by data collection criteria and strategies as described in the previous sections above, and partly through the analytical process.

This paradigmatic positioning is useful in ensuring consistency and fit between research objectives, questions, design and analytical approach, but I subscribe to Miles and Huberman’s (1994) position that research is actually more a craft than a slavish adherence to methodological rules, and that while it may be tempting to operate at the poles in epistemological debates, most researchers are closer to the center, with multiple overlaps in their actual practice of empirical research.

The analytical process of this study may be described within the framework of Miles and Huberman’s (1994) general model for qualitative analysis. They define analysis as consisting of three concurrent flows of activity: data reduction, data display and conclusion drawing/verification. Data reduction refers to the process of selecting, focusing, simplifying, abstracting and transforming the data (and not to the quantification of data as it would be understood in a quantitative study). Data display refers to an organized, compressed assembly of information, and includes a wide variety of formats ranging from extended texts to graphs and charts. Conclusion drawing refers generally to the generation of meaning (finding regularities, patterns, explanations, possible configurations, causal flows and propositions), and
the emphasis here is particularly on theorizing. In the analytical process, verification may be as brief as a fleeting second thought crossing the analyst’s mind during writing, or it may be thorough and elaborate with extensive efforts to replicate a finding in other data.

These three flows of analytical activity are concurrent, including with data collection. As indicated in Figure 4.2, the data analysis starts even before data collection, with data reduction. This anticipatory reduction includes a choice of conceptual framework, cases, research questions and collection approaches, which all necessarily involve data selection and are analytical in nature. Once data collection commences, data display and conclusion drawing/verification activities will also start and continue in an interactive, iterative and cyclical fashion until the final report is completed.

Miles and Huberman (1994) argue that conceptually speaking, the process is no more complex than the analysis modes quantitative researchers use also when engaging in data reduction (computing means, standard deviations, indexes), data display (correlation tables, regression printouts) and

Figure 4.2 - Components of Data Analysis: Flow Model (Miles & Huberman, 1994:10)
conclusion drawing/verification (significance levels, experimental/control differences), but that while theirs’ are carried out through well-defined, familiar methods guided by canons, qualitative researchers are in a more fluid and pioneering position.

Beyond the data selection procedures described in previous sections above, the key data reduction activities in my analysis were the coding and writing of memos and vignettes.

Coding is used to overcome the qualitative analysis challenges of data overload and data retrieval (Miles & Huberman, 1994). Transcripts of long in-depth interviews and a significant amount of documentation amount to a large amount of textual data. Words are “fatter” than numbers, often have multiple meanings and may be meaningless unless seen in contexts (such as “this” or “them”). Compared to numbers, they are harder to work with and cannot be processed in the same economical manner. And within a mass of data of this type, finding the pieces that matter the most is difficult. Coding is therefore used to tag or label specific “chunks” of data (words, phrases, sentences, whole paragraphs, etc.) in which coded data may be retrieved, organized and displayed in a manner that sets the stage for drawing conclusions.

The coding was carried out using the CAQDAS (computer-assisted qualitative data analysis) software NVivo. Here, you start out with three basic categories of codes (or nodes under which you code your data): cases, free nodes and tree nodes. These NVivo nodes work very much in the same manner as designated hanging files do for manual coding, a storage point for each topic or concept (Bazeley, 2007). Case nodes were simply used to allocate data to cases and sub-cases so that data relevant to a specific sub-case or case could easily be retrieved for review and reflection. Free nodes are nodes that do not presume any relationship and connection to other nodes, while tree nodes are hierarchical, branching structures in which parent nodes serve as connecting points for subcategories or types of concepts, representing what Richards (2005) refers to as category systems.

The distinction between data-driven and theory-driven analysis (Eriksson & Kovalainen, 2008) was reflected in the coding used and the dynamic process of working with NVivo nodes. The study’s theoretical framework with its a priori specification of constructs provided a guide to the first sets of codes.
and to their structure within a tree nodes system. For instance, working with TCE, one knows that asset specificity is a key concept that needs to be allocated a node. This parent node would then branch into two sub-categories, non-specific assets and specific assets, and the latter of these would again branch into ex ante specific investments and ex post specific investments. When coded, all data relevant to asset specificity may be retrieved and reviewed under the parent node, while only that part of this data specifically related to non-specific assets is retrieved under this sub-node and the parts specifically related to ex post specific investments is retrieved under that sub-node. Naturally, the amount of data is diminishing the further you go down a specific tree branch. Some tree nodes could also be set up initially for data driven analysis, as for instance when coding for actors/players the players node was already being divided into producers, distributors, and others sub-nodes at the outset, and distributors were again divided into studios and independent nodes before each distribution company was given a separate node in the fourth level of player nodes.

More typical, however, for the data driven analysis was to allocate codes in free nodes since it was unknown in the early stages of analysis as to how the category or topic would relate to others. For example, the node for talent backend participation (which refers to any kind of cash flow or profit share an actor, director or other talent has negotiated to receive from a movie project) was created as a free node. The topic was identified frequently in the data and seemed important even though it was unclear in the early analysis exactly how. However, as the amount of data under this node grew, it was reviewed again and it became apparent that this topic was an integral part of the issue of value claiming for distributors and producers. The node was then moved from free nodes to tree nodes, where it became a sub-node under the parent node of value claiming. This was a two-step, but interactive conclusion-drawing activity of identifying and defining a topic, issue or construct and then placing it in relation to others. Eisenhardt (1989b) refers to the first as the sharpening of the constructs, and names it as a first step in shaping hypotheses. Hence, coding was not only preparing the ground for further analysis and theorizing, but was an integral part of the theorizing process in itself.

The data-driven analysis was dynamic in at least two ways: New topics, issues or constructs would be identified and nodes for each of these created throughout the analytical process, and these nodes would usually only
subsequently be conceptually and structurally ordered. Richards (2005) identifies this type of dynamic and flexible coding as one of the key aspects in which qualitative analysis differs from quantitative. However, in this dynamic and flexible process of coding, organizing the nodes conceptually and structurally is important in order to keep the analytical process effective. As Miles and Huberman (1994:62) argue, without such structure adding, removing or reconfiguring, codes will produce “a ragbag that usually induces a shapeless, purely opportunistic analysis,” and it will make codes harder to memorize and use, as well as making the retrieval and organization of the material burdensome.

The dynamic process of coding also reflects the generally fluid process of qualitative analysis. The three flows of activity in Miles and Huberman’s model above is not neatly separated, but concurrent and interactive. At the outset, coding is a data reduction activity as it identifies some data to be coded and is thus included for further analysis, while other data is not coded for further analysis. The process of retrieving data under a specific node, however, is a simple data display activity, as it shows the chunks of texts coded under the node. Reviewing and reflecting upon the retrieved texts involves both data reduction and conclusion drawing because one now may also uncode data one sees should not be there, which is important to avoid losing focus (Richards, 2005). Finally, the processes of sharpening constructs and structuring free nodes into tree nodes is a conclusion-drawing activity, as it is based on decisions made about conceptual and structural patterns. Verification typically comes in a subsequent stage. Once the node is placed in a tree, further coding using this node in the new hierarchical structure will either verify or contest the decision made when relocating the node. In a similar manner, the sharpening of concepts is verified or contested when coding on. These types of verification processes are named by Eisenhardt (1989b) as a second step in shaping hypotheses.

The more advanced coding was done using what Miles and Huberman (1994) refers to as pattern coding and which Bazeley (2007) refers to as metacoding. While first-level coding labels data relating to a specific category or issue for the primary purpose of summarizing these segments of data, pattern codes are explanatory or inferential codes, identifying an emergent theme, configuration or explanation, and they group the primary code summaries into a smaller number of sets, themes or constructs (Miles & Huberman, 1994). In NVivo, this was done using sets and relationships. A
set was used simply to group items (nodes and sources) that related to a common concept and for labeling this concept. For example, a set was created for \textit{layered P-D contracting}, a concept which refers to situations in which a production company (1st layer) under an output deal (the parent deal) with a distributor subsequently enters into output deals with other smaller production companies (2nd layer), which then also comes under the distributor’s parent deal via the 1st layer production company. This set then included the relevant P-D contracting case nodes, three nodes for the involved players, a tree node for transaction frequency and a memo (source) describing the layered contracting construct. The set was then saved as a node and used in further (re)coding to identify data relevant to this concept. As with first-level nodes, these constructs (sets) were sharpened and verified when coding on and recoding.

A \textit{relationship} was created and used to identify linkages between already identified constructs. The linkage could be a simple association or a one-way or two-way directionality, and it would be marked with the specific type of linkage, most typically \textit{affects} or \textit{is associated with}. These types of relationship nodes are thus more directly related to the theory building. For example, a relationship node was created between vertical and horizontal contracting structures (two case nodes): \textquote{Vertical P-D structure affects Horizontal P-D structure}. As with sets, relationships were saved as nodes and used, sharpened and verified in subsequent (re)coding. When a relationship code was created, data involving the related nodes would be revisited for recoding using the coding query function described below.

Creating the pattern codes has strong elements of a conclusion-drawing activity, and the subsequent use involves verification. In such verification processes the code would never become discounted (since its creation was grounded in data); instead it would be qualified, meaning that the conditions under which it holds were specified (Miles & Huberman, 1994:71). For instance, a relationship code was created for \textquote{Coordination affects Distribution investments} but later qualified for only projects at certain budget levels. This type of verification process is representative of the replication logic central to theory building (Eisenhardt & Graebner, 2007). A pattern code, such as \textquote{Vertical P-D structure affects Horizontal P-D structure} would for instance be considered for numerous “mini-cases” (vertical and horizontal P-D contracting for specific movie projects referred
to in the data) like a series of distinct experiments that serve as replications, contrasts and extensions to emerging theory.

While manual qualitative analysis often required much burdensome work to create various forms of matrices for more advanced data displays (Miles & Huberman, 1994), CAQDAS-based analysis has greatly simplified this process. A key NVivo display function used in this study was the coding query. While nodes themselves offer the possibility for retrieving the relevant coded data under the specific (parent- or sub)node, coding query offers access to what Bazeley (2007:113) refers to as the intersections of coding. In its simplest form, the query allows to ask for data coded under two nodes, e.g. value claiming AND acquisition contracting. Only data coded under both nodes (value claiming in the context of acquisition contracting) are then displayed. Such queries may be extended to matrices with for instance two case nodes horizontally and four free nodes vertically. This creates an eight field matrix in which each field will provide data coded under a specific case and a specific free node. By summarizing the texts displayed for each field, one creates the traditional matrix, which particularly for larger matrices is useful for seeing a complete picture on a single sheet. Some queries were also made more complex, also using OR, NOT and NEAR (such as within the same scope item), retrieving smaller amounts of more specific data. Using these CAQDAS-tools was highly efficient for creating displays as a basis for conclusion drawing and theorizing, but the actual conclusion drawing and theorizing were done by reviewing and reflecting upon the data as displayed. Hence, the CAQDAS-tools should not be mistaken for having the same function as computer-based tools used in quantitative research, which to a greater extent help produce the analytical result. Finally, the efficiency of coding queries was wholly dependent on the quality of the coding. When coding the data it was therefore important to see it from different dimensions. If one is lost in the coding process, that particular chunk of data will not be retrieved when running queries involving nodes along that particular dimension. The idea behind thorough and sound coding is hence very similar to the idea promoted by Eisenhardt (1989b) for cross-case searching tactics: The investigator must be forced to go beyond initial impressions, especially through the use of structured and diverse lenses on the data. A well conceptually and structurally organized coding system provides such sets of lenses.
Besides coding, the writing of memos and vignettes were used for data reduction, display and conclusion-drawing/verification activities. These are subcategories of what Eisenhardt (1989b) generally refers to as write-ups. Writing memos, or memoing, was used to create theorizing write-ups of ideas as they struck, typically about codes (first-level and pattern), sets, relationships and queries. Memos would be brief, from only a few sentences and seldom more than one page, and they were written by myself to myself, often in a stream-of-consciousness manner, without paying careful attention to the language. The primary function was to capture ideas as they occurred while working with the data, so these memos could be seen as field notes from the analytical process. Many times these memos would be elaborated upon, but then usually in the form of a new memo, and some of these again would become important foundations for thematic sections in the following chapters. As suggested by Miles and Huberman (1994:73), memos were always linked to particular data and nodes, and they were themselves coded and saved in NVivo as data was. In this way they could be retrieved together with relevant data and be displayed together with that data.

Vignettes were used for slightly different purposes. These were written to produce a focused and coherent description of a series of events or a phenomenon that in some way was considered to be representative and typical. One example could be a specific production-distribution relationship reported in several trade journal articles or a specific theme touched upon by several of the interviewees. Compared to the memos, they would have a more narrative, structured format and typically be somewhat longer. Writing the vignettes most often proved helpful in formulating core issues and my theories of what was happening.

Applying these analytical methods, the analysis followed a within-case and cross-case strategy as suggested by Yin (1981) and Eisenhardt (1989b). The goal of this strategy is to become intimately familiar with each case as a stand-alone entity to discover unique patterns of the case before investigating patterns across the cases. However, my application of this strategy was less sequential than the description provided by Eisenhardt (1989b) may indicate. This may partly have been because data collection for the cases was parallel and not sequential. Insight and understanding of the cases thus grew at a somewhat similar pace, and as an interesting theme would appear in one case it would typically immediately also be analyzed in the context of the other. Then as part of the cyclical process of developing
the understanding of the theme in the context of both cases, data collection
adjustments were also done in some instances (adding a question to the
interview guide, searching and collecting additional articles, etc.). Hence, a
more strict sequential order of the two analytical processes did not seem
practical in this study. Yet, as described here, the themes emerging were
usually triggered by an enhanced understanding of a case so that the
sequential order of analysis per theme would still go from within-case to
cross-case. Finally, while the early stages of analysis involved intense
within-case analysis gaining a clearer understanding of each contracting
form and their implications, the later stages of the analytical processes were
mainly focused on finding cross-case patterns. It could therefore be said to
be an overlapping analytical process in which the focus shifted from within-
case to cross-case analysis as the study advanced.

4.7 A Note on Theory Building

In general, theory is developed through incremental empirical testing and
extension (Kuhn, 1970), and more specifically these two approaches consist
of deductive theory testing and inductive theory building (Parkhe, 1993;
Perry, 1998). Theory development using a case study approach does indeed
involve a significant amount of inductive theory building, and this is
sometimes confused with a more radical approach of pure induction. This
extreme induction school is most significantly rooted in the grounded theory
approach, in which the objective is to generate theory from data alone
(Glasser & Strauss, 1967). The extreme position of grounded theory research
is one where “logico deductive” theory is discarded and there is no theory
under consideration and no hypothesis to test. This extreme position has later
been refined; acknowledging that in practice it is difficult to ignore the
theory accrued in one’s mind before commencing the research process
(Strauss, 1987).

A somewhat similar approach to the case study strategy has been proposed
by Eisenhardt (1989b), who argues that theory-building research is begun as
close as possible to the ideal of no theory under consideration, and that
preordained theoretical perspectives or propositions may bias and limit the
findings. However, Yin (1994) argues that the relationship to theory before
commencing the research is a key difference between case studies and
grounded theory. According to his view, theory is indeed useful for
structuring the study and essential to the design phase. Pure induction may

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prevent the researcher from benefiting from existing theory, just as pure
deduction might prevent the development of new and useful theory. Parkhe
(1993), Perry (1998) and others argue in a similar fashion as Yin that both
prior theory and theory emerging from the data are always involved and that
it is impossible to go theory-free into a study.

This study is both deductive (theory inspired) and inductive (data inspired).
As shown in this chapter, it involves deduction based on prior TCE theory in
its approach to both research objective and questions, and for a case study
the initial framework may thus be described as somewhat “tight.” Some of
the main advantages of this “tight” framework are that the research question
and definition of key constructs and variables are very specifically set at the
start of the research process, which makes the study more economical. For
instance, case selection as well as the initial data collection and initial coding
scheme followed from deduction. Furthermore, since the relationship
between governance structure and specific investments is thoroughly
discussed in the TCE literature, which also includes calls for an endogenous
treatment of specific investments (Bensaou & Anderson, 1999; Kang et al.,
2009; Macher & Richman, 2008), the risk of “discovering” existing theory is
greatly reduced by not taking a pure inductive approach. Yet, the key
contributions sought by the study follow from its inductive work. Such
inductive work is called for in the research objective of identifying
intermediate variables to help explain the relationship from contracting
forms to specific investments. It is also at the heart of the analytical work
with the various conclusion-drawing activities, as well as more generally
throughout the data driven analysis. In sum, while inspired by Eisenhardt’s
(1989b) approach to building theory from case studies, which some label
inductive (Welch et al., 2011), this case study involves strong elements of
both induction and deduction in its theory building.
5 Transactions in the Motion Picture Industry

This chapter will provide a description of the context within which the investments and transactions of interest take place, the American motion picture industry. Following a brief overview of the industry’s size and scope, the industry value configuration system is discussed as a framework for categorizing and organizing the numerous transactions involved in any movie project. Then, systematically following the industry value system, but on a micro-level, key transactions are described based on documentation and interviews and then discussed in terms of transaction-specific investments, uncertainty and frequency with producers and distributors as focal transaction partners. Since it is the transaction between these two partners for a movie project, the production-distribution transaction, that is our ultimate interest, the micro-level transaction attributes are primarily discussed in relation to this transaction and not each individual micro-level transaction. The chapter is concluded with a summarizing discussion of these transaction dimensions from a project-oriented perspective. As such, the chapter builds a foundation for understanding and discussing the various strategies of organizing and integrating these micro-level transactions as represented by our cases of higher-level producer-distribution transactions, which are discussed in the following chapter. Contracting related directly to production and distribution investments, and how these are related to the production-distribution transaction, is also discussed there. The bottom-up analytical approach of these two chapters to help in understanding the production-distribution transaction for a movie project is illustrated below in Figure 5.1.
Figure 5.1 - The relationship between micro-level transactions covered in Chapter 5 and the higher-level production-distribution transaction cases covered in Chapter 6

5.1 A Substantial and Commercially Driven Industry

The production and distribution of motion pictures is a significant industry in the United States. Recent aggregate figures for theatrical motion pictures only is difficult to find, but in 2009 the industry employed 272,000 people in the core business of producing, marketing, manufacturing and distributing motion pictures and television shows. Additionally, there were over 430,000 jobs in related businesses that distribute motion pictures and television shows to consumers. The industry created USD 13.8 billion in film and television exports, making it one of the more important US export industries (MPAA, 2011a). In 2010, gross theatrical ticket sales, referred to as Box Office in the industry, was USD 10.6 billion in North America (US and Canada), typically referred to as Domestic Box Office, and USD 21.2 billion in the rest of the world, typically referred to as International Box Office (MPAA, 2011b).

Unlike the film sector in European countries, the American motion picture industry operates as a private sector commercially-driven industry independent of direct government financial cultural support and
accompanying regulations. While European governments have historically tended to treat their film industries within a cultural policy perspective with an emphasis on protectionism and national cultural production, the US government has primarily supported its movie industry as an important export industry fighting trade barriers such as culturally rationalized import restrictions in export markets (Finney, 2010; Putnam & Watson, 1997). As a result, the American industry operates in a market economy setting with relatively few industry-specific restrictions and regulations, so it is fair to assume that the transactional patterns found are based on competitive mechanisms that have favored the more efficient modes.

5.2 The Motion Picture Industry Value System

We are interested in production-distribution transactions for specific movie projects – the contracting between the production activities and the distribution activities required for a specific movie. These are bundles or categories containing numerous micro-level transactions. As a framework for describing both the context and complexity of the production-distribution transaction, Porter’s (1985) value system and value chain models are useful. The industry’s value creation logic is basically that of transforming various creative and humdrum inputs into products in the form of movies (Caves, 2000), and as we shall see, the main interactivity relationship logic is sequential and the industry value system structure is best described as the interlinked chains of the firms. Together, these characteristics fit well with Porter’s value configuration models, which are associated with Thompson’s (1967) long-linked type of technology that involves serial interdependence (Stabell & Fjeldstad, 1998).

It should be noted, however, that within this value system, in which the primary transactions are best understood as creating a value chain, there are elements, particularly in the production function, that rely on intensive technology (Thompson, 1967) and would therefore fall under Stabell and Fjeldstad’s (1998) value shop configuration. The inputs required are dependent on the movie’s unique requirements, thus the variety of inputs drawn upon changes from one project to another. For this reason, the frequency of each particular micro-level transaction remains low and prevents a higher degree of integration, even in the presence of asset specificity and uncertainty.
Figure 5.2 The Basic Loop: Product and money flows in the American motion picture industry (Murphy, 1995a)
An empirically derived model of the product and money flows that provides a good basis for a value system model is provided by movie industry analyst A.D. Murphy (1995a) in Figure 5.2 above. Murphy named it The Basic Loop since it shows the circular flow of product and money between creative inputs in one end and the movie consuming public in the other. Transactions between various activities are indicated by the solid output and dashed money arrows, while the boxes indicate integrated activities. Here, the industry is divided vertically in three main sectors according to their functions: production, distribution, and exhibition, which is the most common vertical industry division used in both practice and literature (Finney, 2010; Hadida, 2009; Litman, 1998; Wasko, 2003). Production covers all activities required to create a movie from concept to a completed viewable product. In the distribution sector, marketing and licensing activities are carried out to build a potential audience and make the movie available in the various market channels. The exhibition sector, which earned its name based on its historic ties to movie theaters but more generally could have been referred to as the movie retail sector, presents and makes the movie available for consumption by end users. Hence, in its simplest form the industry value system may be shown as in Figure 5.3 below.

![Figure 5.3 - The motion picture industry value system](image)

For this study, the primary interest is in understanding the transaction joining production and distribution value chains for a movie project – the production-distribution transaction – and the transaction-specific investments made in view of this focal transaction. To that end, the examination of micro-level transactions in the production and distribution sectors is emphasized in the following sections. Exhibition is included to complete the picture with an emphasis on its implications for production- and distribution-related transactions.
5.3 Production Value Chain Activities and Transactions

In John W. Cones’ dictionary of terms for the motion picture industry, “production” is defined as “[…] the processes involved in making all the original materials that are the basis for a finished motion picture” (Cones 1992). Production is therefore similar to the popular understanding of “film-making.” It includes all activities necessary to complete a first copy of the movie. As key activities Murphy (1995) lists in sequence: the initiation and development of the project, the preparation of the script, the hiring of the director, cast and crew, the physical planning of production, the rehearsals and tests, the budgeting, the principal photography and the post-production, all of which are included in the production function shown in Figure 5.2. Note that creative, technical and material inputs to the production function are shown separately to the far left from the production box, thus indicating the frequent use of independent contractors and freelance workers (Blair, Culkin, & Randle, 2003) and the low degree of integration between the production entity and inputs.

The production function is typically broken down into three stages or categories of activities: development, production and post-production. However, for the purpose of this study it will be split into more strategically important groups of activities: development, packaging and production (Figure 5.4), each of which will be discussed below. Compared to the former set of categories, it defines packaging as separate from development and combines production and post-production into one. Several of the interviewees identified packaging specifically as a strategically important set of activities for a movie project since this is where key elements such as the lead cast and director are determined. Production and post-production are film-making activities historically split into those taking place before and after the cameras stop rolling, but in terms of key variables to this study (investments, uncertainty, transactions) there is no significant difference between these activities; consequently, they are treated as one activity group.

Figure 5.4 - The production value chain
5.3.1 Key Development Transactions

Development describes the initial stage in the preparation of a movie, those activities relating specifically to taking an idea or concept and turning it into a finished screenplay (Cones, 1992), as well as those required to create a production cost estimate of the screenplay (Clevé, 2006). It includes formulating and organizing the idea or concept for the movie, the acquisition of rights to the underlying literary work or screenplay and preparing a screenplay, that together with its production cost estimate is complete and finished enough to support a decision to produce or not.

The Screenplay Transaction

The screenplay transaction may be defined as the transaction between the producer or production company that wishes to make a movie and the writer(s) carrying out the creative work. It may furthermore be split into two stages or two transactions, the first related to the movie concept and the second to the screenplay.

First, considering the concept, any random sample of movies is likely to reveal that the origin of movie projects varies widely. It may be a rather vague idea in the form of an original concept conceived by a producer, director or screenwriter, a concept based on a newspaper or magazine article or the desire to make a movie based on a comic book figure. Or it may be a much thicker and richer idea in the form of the desire to adapt an existing literary property such as a novel, short story or stage play into a movie. Further still, it may be the idea to make a remake of an existing movie, a movie based on a TV series or any idea arriving from numerous other origins. Hence, the concept transaction may be fully internalized (when the concept is originated by the producer), market based (when the producer acquires the concept, such as buying the movie rights to a comic book) or of a hybrid type (when for instance the producer collaborates with one or more writers).

Regardless of what the origin of a project may be, the preparation of the screenplay is a key development activity. In this process, the movie idea is developed from the original concept to a finished screenplay that specifically describes the movie’s story through every scene with dialogue, action and environments. The process is typically done in stages of increased specificity, starting with a synopsis covering the basic idea, story and characters, and then adding more detail in an outline, including the full story
and better character descriptions, before finally arriving at a full screenplay. The process usually continues with rewrites and polishes of the screenplay, adjusting it to creative inputs from director, actors, producers, etc., which is dependent on who is involved or attached to the project at this stage, as well as to production, technical and economical requirements.

The screenplay transactions are often of a hybrid nature: The writers are not permanent employees of the producer, but all screenplay development activities are carried out under the control of a producer where the writers are contracted and paid by the producer as they write. The writer’s output is deemed work-made-for-hire owned by the producer (Baumgarten et al., 1992). In Figure 5.2 the writer is then the creative input at the far left contracted by the producer.

However, a large number of screenplays are created by writers working independently of producers, and when they do it a more or less finished screenplay is acquired by the producer, making the screenplay transaction between writer and producer resemble a market transaction. In the industry, these screenplays developed without a producer are referred to as spec scripts since there is no guarantee that they will ever be acquired by a producer and get any further from the writing stage into the development and production processes. According to the interviewees, there is a saying in Hollywood that every waiter in Los Angeles has a spec script he or she is constantly trying to sell producers who are eating out. While this is an exaggeration, there is a large number of spec scripts being written every year and the quality of these obviously vary a great deal. This represents a challenge for producers trying to identify the best scripts suitable for production and with limited resources, primarily in the form of having the time to review the large number of scripts available. Spending resources on obtaining information about the quality of a screenplay by hiring dedicated readers is therefore an important transaction cost associated with screenplay market transactions. While readers are employed or hired on a freelance basis by producers, the demand for these search and quality assessment activities have also created a market for literary agents whose primary function is to identify quality writers and scripts, take on representation for these writers and scripts and then secure the best possible terms for these when contracting with producers (Rosenberg, 2004). Most established producers only assess spec scripts brought to them by agents, and do not accept unsolicited scripts – thereby outsourcing much of the search
activities. While the vast majority of spec scripts never receive any interest, attractive spec scripts – typically from already established writers – sometimes trigger intense bidding wars among producers in a very typical market transaction manner (see Box 5.1). Yet, once a producer has acquired a spec script, the producer may want to continue the screenplay development process by hiring the original writer and/or other writers to carry out further rewrites, adjusting the screenplay to production requirements or creative requirements from the director and/or actors. This continuation of the screenplay transaction would then take a hybrid form similar to that discussed above.

**Box 5.1**

Variety reports on a spec script acquisition (Swanson, 2001):

*On a recent October afternoon, five Hollywood studios joined Regency Enterprises [a production company] in a heated bidding battle for spec script "Stay," a supernatural thriller buzzed as the next "Sixth Sense."

As offers crested the million-dollar mark, Regency decided to call the competition with a $1.8 million progress-to-production offer, promising to start making the David Benioff-penned pic within a year. And the company insisted on an immediate answer.

"I knew if we got off the phone, we wouldn't get a second chance at the script," recalled Regency production prexy Sanford Panitch, who, with CEO-prexy David Matalon, had conferenced in Regency topper Arnon Milchan to negotiate with the agents.

The gamble worked and the spec joined a flurry of recent projects initiated by the Fox-based mini-major.

The movie was produced with a production budget estimated to USD 50 million, directed by Marc Foster and starring Ewan McGregor, Ryan Gosling, Naomi Watts and other stars. It was released in 2005 but performed modestly with a total domestic box office gross of USD 3.6 million during its six week theatrical run. It never made it into the weekly top 10 list (IMDbPro, 2011b).

Fully integrated screenplay transactions are rare and generally only occur when an individual producer is also a writer, and even then, primarily to
make transparent the chain of rights ownership (the chain of title), a contract is typically made between the writer/producer and the production company specifically for each screenplay in a hybrid transaction manner as discussed above.

**Specific Investments**

In a narrow view of this micro-level transaction alone, specific investments are low or absent. Typically, no specific assets supporting the screenplay transaction will be required. The writer is likely to use some specific screenwriting software, but even these modest investments will not be specific to any particular transaction or relationship. However, we are not interested in the making of the screenplay itself, but in the screenplay transaction as one of the micro-level transactions on the production side in a project’s production-distribution transaction. Our ultimate interest is in understanding asset specificity in relation to the production-distribution transaction for a movie, consequently the following discussion of the specificity of screenplay investments is in the project perspective of this focal transaction. And seen from this view, the creation of the screenplay is in fact the making of a specific asset supporting the production-distribution transaction.

Investments made into creating and securing the ownership of the concept are transaction specific to the degree the value created is reduced outside the context of the particular production-distribution transaction or outside movie project. Specificity may therefore vary depending on the nature of each project. When purchasing movie rights to an existing property, it will be high since those rights will have no value outside the context of producing a movie based on the property. Specificity will be lower when a producer works with a team of writers to create a concept for a particular type of movie. If the team comes up with a concept for a children’s animated movie, there may be elements or ideas from this concept that can be carried over to other similar movies if the particular project should fail to be realized and the loss of value is limited accordingly. However, it is hard to think of any situations in which a loss could be eliminated, so it is fair to assume that these investments always – but to varying degrees – will be specific.

Investments into the next step will generally be more specific since the output created is more specific to the movie project, and increasingly so the further out in the process from synopsis towards rewrites and polishes one
gets. Scenes, characters and dialogues can most often not be redeployed from
the movie for which they were created to other projects without a significant
loss of value. And the full screenplay cannot be redeployed since it defines
the movie project. Investments made into the screenplay will thus have a
high degree of specificity.

Often, the producer will seek to limit the scope of these early specific
investments by utilizing various forms of option contracting (Baumgarten et
al., 1992; Caves, 2000; Litwak, 1998). If an acquisition type of screenplay
transaction is made, the contract may be structured so that only a relatively
modest option fee is paid up front, with full payment only due upon the first
day of principal photography, i.e. after a positive production decision is
made for the project. Similarly, in hybrid types of transactions, the up-front
writer fees may be kept low with higher bonus payments becoming due upon
the commencement of production, and only if the project is realized.
Nonetheless, while such forms of option contracting reduce producer’s
initial specific investments, they do not reduce the specific investments made
into the project in terms of the resources spent. Instead, they only
temporarily shift part of the investments from the producer to the writer.

Only in terms of byproducts will there be elements of non-specificity in the
screenplay transaction: The producer create a valuable relationship with the
writer, the producer gains credibility for working with an established writer,
and so forth.

Uncertainty
As with most transactions in creative industries (Caves, 2000), the
screenplay transaction involves a great deal of uncertainty with regard to the
quality of the output. At the very first stage in a movie project when the
screenplay transaction is initiated, the information available about the nature
of the finished product may vary from something as vague as a key concept
written down on a restaurant napkin to something as specific as an existing
novel or stage play. Either way, the uncertainty must be regarded as high
since the quality of the screenplay, the cast, director, the production and
everything that comes after is unknown.

As the work progresses, information about the nature and quality of the
output is gradually revealed. Accordingly, a standard writer’s contract used
for hybrid types of screenplay transactions will typically have a structure in
which the producer has the option to continue working with a writer on each subsequent step of the process (synopsis, outline, screenplay, rewrites and polishes) to predetermined terms and conditions that follow a review and assessment of the latest submitted output (Farber, 2001a; Litwak, 1998). These so-called step deals somewhat reduce a producer’s risk, as writers can be replaced in the process if the quality of their work is not satisfactory. But even so, uncertainty about the quality of the ultimate output, the movie, will be significant this early in the production process.

There may not only be uncertainty about the quality of the work, but also with regard to the more general direction the partners involved wish to take for the particular project. An example is provided in Box 5.2.

Box 5.2

Johnny, a producer, provides a brief description of the development process for one of his past movies:

So, as with [Movie Title], I sold [Distributor] a book and then we wrote a script and then we re-wrote the script and then we re-re-wrote the script; then we found the director, we re-wrote the script, then we lost the director, then we found another and then we lost the director and then we found another, rewrote the script and another script and then they [the Distributor] said, “OK, let’s make a movie.”

Johnny, Producer/President, pact production company

So while a writer contracted in a hybrid type of screenplay transaction is working under the control of the producer, the producer will have to adjust the directions given to the writer to fit the wishes and requirements from other parties on which the producer depend in order to realize the project, as exemplified in the quote by a distributor and a director who is at one point replaced. This generally adds to the uncertainty under which the screenplay transaction takes place.

When market type transactions are used and the producer acquires a spec script, the uncertainty about the quality of the outcome is eliminated since the screenplay is already written. However, the uncertainty about the quality of the movie remains high and the producer may also not be certain that the
movie can be produced. Due to this latter uncertainty option structured contracts are frequently used to reduce a producer’s risk. As described above, the producer then only pays an option fee up front and the full acquisition price typically upon the start of principal photography. Hence, if a positive production decision is not reached for the project the producer’s loss on this particular screenplay transaction is limited to the option fee (and the rights fall back to the writer). However, in a market environment this approach may not work for attractive screenplays, as illustrated by the example in Box 5.1. In this particular transaction, the producer not only commits the full acquisition price, but also makes further commitments to actually produce a movie based on the script and to start production within a specified time limit.

Like in most other industries, environmental uncertainty may also affect the screenplay transactions, and the possibility of strikes has turned out to be particularly relevant here. Most professional American screenwriters are organized in the Writers Guild of America (WGA), so the impact of a WGA-initiated strike would be significant. The effects of a strike would mostly be felt through the difficulties of initiating new transactions, but it may also affect ex post, as shown by the example in Box 5.3.

**Box 5.3**

In the summer of 2007 United Artists, a production company, made a positive production decision on “Pinkville,” a movie about the My Lai massacre to be directed by Oliver Stone, with actor Bruce Willis attached for the lead role. When the WGA went on strike from November 2007 through February 2008 the project hit a roadblock due to script problems that could not be resolved. The strike prevented the writers from performing the necessary rewrites and polishes in time for the movie to be produced within the time window Stone and Willis had set aside for it. Consequently, the project was abandoned (Fleming, 2008e).

**Frequency**

The frequency of screenplay transactions between specific writers and producers is generally low. Most writers work with a number of producers and vice versa. A writer and producer may therefore not work together on more than one project, and if they do, the projects will most likely be years apart. Exceptions are sequel movie projects, in which the producer will often engage the same writers again and when semi-permanent teams of freelance
workers (Blair, 2001) include a writer. Writers may also utilize the services of agents, which will affect frequency, as discussed in detail for the packaging transaction below.

**Other Transactions**

Other important development work includes preparing a schedule and budget for the production. Based on the screenplay, a project breakdown is prepared from which a detailed list of the resources required to produce the movie is derived. This provides answers to questions that include how many days are needed to shoot it, how many actors and actresses are required for what amount of time, what kind of locations, sets and studio constructions are required, what visual effects are required, etc. Based on the resource estimates, a first draft production budget is created that indicate the total cost of production (Clevé, 2006). Certain cost elements, will still be unknown until all key inputs are determined, such as the compensation paid to star talent (Blume, 2006), but with the screenplay and budget in place, a producer is able to provide a quite detailed description of the desired movie and a fairly accurate estimate of its total production costs, assuming a specific level of star talent being involved.

The budgeting and scheduling transaction may be integrated (carried out by the producer or permanent employees of the production company) or hybrid (a freelance producer or production manager is hired to carry out the work under the producer’s control and supervision). Compared to the screenplay-transaction, the required resources and investments are moderate but specific since a budget is only relevant for the screenplay upon which it is based. Uncertainty with regard to the quality of the output is lower and can more easily be reduced, and will primarily depend on the experience of those carrying out the work and on the complexity and novelty of the project. The transaction frequency is higher than for the screenplay transaction, as it is typically the same personnel doing budgeting and scheduling for all projects that a production company handles. Working with the same personnel is also a means to reduce uncertainty as the production company learns who has delivered high quality work on previous projects.

**5.3.2 The Packaging Transactions**

The packaging transactions are those whereby the producer obtains commitments from the key talent to participate in the movie, thereby significantly reducing uncertainty about its final shape. The most important
and common packaging transactions are those made for the director and actors for the leading role(s). Before providing a commitment, the talent will evaluate the mini-package of producer and screenplay, the financial compensation offered as well as any proposed schedule for production and possible scheduling conflicts with other projects the talent has accepted or considered.

Packaging transactions typically takes market or hybrid forms. It may resemble something close to a market transaction for an actor considering the attractiveness of the role (screenplay quality) and financial compensation against other competing offers. Or it may take a more hybrid form for a director who is asked to also participate in the further development of the screenplay, and who may also be offered certain out-clauses should the project not develop in a satisfying way. Integrated transactions are rarer since the talent in most cases will not be tied to any particular production company. The exceptions are found in those cases in which the talent is in fact already part of the production company. For instance, director Steven Spielberg is an owner and executive at Dreamworks, so when Spielberg decides to commit to a Dreamworks movie as a director or producer the transaction may be seen as being integrated. However, Spielberg may still decide to make a strong enough distinction between his roles as owner and executive on the one hand and director and producer on the other to tip the transaction over to a hybrid category. Similarly, a number of star actors own or are partners in production companies. Actor Brad Pitt is a partner in Plan B, a production company that produces movies both starring and not starring Brad Pitt. So when Plan B packages a movie with Brad Pitt, the packaging transaction may be seen as being integrated even though Pitt is also likely to distinguish between his role as a company partner and actor.

Packaging transactions may also be interdependent. A certain director attached to a project may attract certain actors and one actor may attract another, and in these instances the packaging transactions takes on a certain snowballing nature. For example, upon the announcement of a new alliance with acclaimed director Martin Scorsese, Paramount’s chairman Brad Grey stressed Scorsese’s ability to attract top actors: "For the last year and a half, my priority has been to attract the best talent we can, both in front of and behind the camera. I wanted to create a home here for Marty. I believe that talent attracts talent, and we're honored to have him here" (McClintock, 2006a).
Packaging transactions involve ax ante and ex post transaction costs. For talent, who in most cases lack business training, even the ex ante transaction costs of assessing offers and negotiating sound deals for the ones they want to pursue may be overwhelming in view of the limited time most wish to spend on such matters. These transaction costs thus create a market for agents; as a result, talent agents and agencies often play an important part in packaging movies. The agencies represent talent, helping actors, directors and other talent to procure work, negotiating contract terms with producers on the talent’s behalf, and so forth against a fee typically calculated as a percentage of the talent’s compensation (Tuchinsky, 2004). Their operations are licensed and regulated by the states (Cones, 1992), and most importantly in the context of this study, Hollywood agents are prevented from acting as producers by the California Talent Agency Act, which forbids agencies from splitting profits with employers (Fleming, 2006). The packaging is therefore always controlled by a producer, but to optimize the scope of their operation and their own revenues, agencies may sometimes insist on tying their more attractive talent to the less attractive among their clients in the packaging for a movie project, thus bundling the packaging transactions. A producer may only obtain access to a popular actor if the producer also agrees to hire other less known clients for other parts, or the agency may decide to promote the career of a new and upcoming director by teaming him or her with a popular actor on their client list. Johnny, a producer operating under an output deal, gives an example:

*Often the agency of the director... when a director is in on the movie... I don’t have an agent. Producers don’t have agents. Directors have agents and they call up their agency. In our case the director is this guy, named [Director]. He is a client of [Major Agency]. He makes a lot of money as a writer. You know [Blockbuster I], he re-wrote [Blockbuster II] and [Blockbuster III]. He makes a lot of money as a writer. And he says, “Look I wrote this little script and I wanna get this made as director. Will you guys help me to get actors?” And they say “OK”. So it’s not an accident that [Star Actor I], [Star Actor II], [Star Actress I] and [Star Actress II] are all [Major Agency’s] clients. All of them!*

Johnny, Producer/President, pact production company
Finally, a light form of packing transactions is made when talent or their agents issue a letter of intent (LOI) to the producer. The LOI typically states that the talent wishes to participate in the project provided certain conditions are met, and these typically include financial compensation and availability. Hence, an LOI does not commit the talent and may not be legally binding (depending on the language used) (Cones, 1992).

Specific Investments
The packaging transactions require investments to cover transaction costs, but on the producer’s end also in some cases production costs in the form of option payments, often referred to as so-called holding money (Garey, 2006). Since a talent’s time is valuable, they will not always pledge their availability to a particular project and thus block out competing offers for the same time-period without some payment for which they will be willing to give the producer a temporary hold on their services. For LOIs, no commitments are made, and thus no payments are made in return.

In the packaging transaction the talent commits to a specific movie, often also based on a specific screenplay. Hence, the commitment cannot be shifted to any other of the producer’s movies without full renegotiation and the talent’s option to drop out. Investments made into the packaging transactions are therefore highly specific, as they cannot be reallocated to other projects without a significant (full renegotiation) or complete (drop out) loss of value.

The direct transaction and production costs for the packaging transactions are moderate relative to a movie’s full production budget. On average, approximately 10% of the total production costs is spent in development and packaging (Finney, 2010). However, the offers made to talent and contracts made will include a financial compensation payable upon the start of principal photography, and for star talent typically also in the form of contingent compensation payable from the movie’s revenues. For this reason, the implied costs of talent fees triggered upon the start of principal photography may be significant, as star talent receives fees up to 20 million dollars or more and such fees can represent one-third or more of a movie’s production budget. While in some cases the fee is only payable when and if the project goes into principal photography, producers may in other cases commit to the full fee in a variety of ways. Producers may commit to actually producing the movie (similar to the example given for screenplay
rights in Box 5.1). Such commitments are known as pay and play deals - the producer commits to producing the movie and utilizing the services of the talent (Cones, 1992). From the talent’s perspective, these forms of commitments are particularly important if the financial compensation offered is principally contingent compensation. A more common form of commitment to the talent is a contract in which the producer offers a fixed fee that will be paid whether or not the services of the talent are required. If for any reason the project does not proceed to production the producer’s commitment is limited to paying the talent’s fixed compensation, while the talent, who foregoes the opportunity to appear in what was obviously perceived as a desirable vehicle, may experience some down-time and is also cut off from any contingent compensation related to the project. These types of packaging contracts are known as pay or play deals (Cones, 1992).

In sum, the investments associated with packaging transactions are highly transaction specific, but may vary in size from moderate if no or little holding money is involved to significant if any pay or play (or indeed any pay and play) deals are utilized. However, even in the latter case of significant investments, the producer’s cash flow is limited to option payments.

Again, it may be argued that investments are partly non-specific in terms of byproduct outcomes (building relationships, reputation, etc.) in a similar fashion as discussed for the screenplay transaction above.

Uncertainty
Similar to that discussed with regard to writers for the screenplay transaction, there will always be some degree of uncertainty related to the talent’s performance. However, this is production-related uncertainty, and not directly related to the packaging transaction. The objective of the packaging transaction is to add key creative inputs to the movie project, thereby creating a better basis for the production decision and making it a more informed decision. The mini-package of producer and screenplay may be good, but only very good and sufficiently strong for production when allied with these other creative elements through the packaging transactions. Caves (2000) argues that movies have multiplicative production functions, meaning that a weakness in one key input cannot be compensated by the strength of others. This obviously further strengthens the demand for the quality, fit and completeness of a project package ahead of the production
decision. In this more narrow view of the packaging transaction, the relevant properties of the contracted elements – the talents’ popularity, creative strengths and style, track record, etc. and hence their estimated value to the project – will be known when the packaging transactions are initiated. This reduces the uncertainty related directly to the packaging transaction.

Packaging transactions may be subject to behavioral uncertainty. Talent may change their minds about projects and behave opportunistically if other more attractive offers are received ex post the packaging transaction, but before services are rendered. Talent’s ability for such opportunistic behavior greatly depends on the extent of the producer’s safeguards built into the packaging contract. However, since the packaging transaction is typically made prior to completing the final draft screenplay used for production (the so-called *shooting script*) talent is sometimes given screenplay approval. As illustrated in Box 5.4, the talent may refuse approving the script as a way to terminate their commitments.

**Box 5.4**

Variety reports (Fleming, 2008f):

> [Universal’s] crash course in talent relations came last year in their efforts to get "State of Play" into production. Weeks before it was to begin shooting, Brad Pitt left the project. The studio threatened to sue, putting them at odds with the actor and his reps at CAA [a talent agency], who maintain that he never signed off on the script. But the parties cooled down after U landed Russell Crowe for Pitt's role, and there are now settlement talks that could even put Pitt in a future U movie.

Taking a broader view, it follows that the objective of the packaging transactions is to reduce uncertainty with regards to the ultimate output, the movie and its market performance. The packaging transactions add another level of important information about the particular movie project: who will direct and who will star in the movie. These two elements are perceived in the industry as being among the most important, apart from the qualities of the screenplay, in determining a movie’s commercial potential. This view is supported by Hadida (2010), who found that these were the two independent variables with the strongest direct and indirect effect on a movie’s commercial success. These results are also consistent with most other studies.
of correlations between talent and a movie’s commercial success (see Hadida (2009) for an empirical research review).

With a director attached to a project, it can be better assessed in view of the director’s previous work in revealing information about his or her particular style, strengths and weaknesses, ways of approaching creative challenges, ability to work with talent and technical crew, and so forth. The director will often also provide a detailed statement about his or her vision for the project, thus providing valuable information about the anticipated nature of the finished movie. Finally, but not least important, with the director being identified it is easier to assess the operational risk of the production itself. Some directors, as for instance Terry Gilliam (“Life of Brian”, “The Adventures of Baron Munchausen”, “Fear and Loathing in Las Vegas”), have a reputation for being artistically and creatively brilliant, but also generally “out of control,” thereby adding uncertainty about the producer’s ability to execute the production in accordance with the budget and schedule. In Terry Gilliam’s case, this reputation comes from having directed several highly acclaimed movies that experienced serious difficulties during the production process and many of the difficulties have been – justifiably or not – blamed on Gilliam’s way of working (Fulton & Pepe, 2002).

Obtaining commitments from actors to take lead roles in a movie is perceived as important for two related reasons. First, knowing who will play a part makes it easier to assess the anticipated quality of the role performance - does the actor fit the character, what qualities will the actor add to the character, how will the character in the person of this actor work with other lead characters, and so on. Second, star actors are perceived as a key tool for marketing a movie and are therefore also a key determinant of a movie’s market value.

A number of studies have been carried out that test whether star lead actors can be consistently correlated with stronger market performance, and while not all can identify a positive relationship, the majority do – to some degree – record a correlation (Hadida, 2009). Among the more interesting studies is one by De Vany and Walls (1999), who collected data for 2,015 movies released in the closed interval from 1984 to 1996 and found that only 19 stars (17 actors and 2 directors) had a statistically significant impact on a movie’s probability to become a box office hit. But even among these top stars, none could guarantee a hit. They all faced infinite variance, thus
bringing a measure of risk with them, and the strength and certainty of impact varied. For example, the study indicated that Tom Hanks had the most certain impact, but that it was smaller than that for others, including Tom Cruise, Jim Carrey and Michelle Pfeiffer. The authors conclude that while some actors do have a significant impact, no star can guarantee any outcome and that every star has a sizeable probability of making “a bomb.” Nevertheless, the positive impact of top stars identified by De Vany and Walls reflects the perceived value of the most attractive talent in the industry. The scarcity of those top actors who actually have a possible impact on a movie’s commercial success is reflected in the compensation paid to them, which in some cases reaches more than USD 20 million per movie (sometimes as much as one-third of the total production costs) (Fleming, 2008a) that are typically paid as advances against shares of up to 25% of a studio distributor’s gross income from the movie (Blume, 2006; Dunkley & Brodesser, 2002). And as discussed above, these payments are often also guaranteed in the packaging transaction using pay or play (and sometimes pay and play) deals.

Frequency
As with screenplay transactions, the frequency of packaging transactions between a particular producer and a specific talent is low. However, with talent agencies involved as middlemen, the transaction frequency between producer and agency on the one hand and agency and talent on the other is significantly higher. The agency handles all packaging transactions for the talent and is involved in every transaction the talent is party to. The “Big Four” talent agencies – William Morris Endeavour (WME), Creative Artists Agency (CAA), International Creative Management (ICM) and United Talent Agency (UTA) – represent most of the top talent, so a producer is likely to do packaging transactions involving one or more of them for each movie project. Moreover, as discussed above, agencies may wish to bundle these transactions further increasing the frequency.

The higher frequency resulting from involving agencies may curb opportunistic behavior since such behavior between producer and talent not only strains the relationship between these two transaction partners, but also between the producer and agency or the agency and talent. In the example provided in Box 5.4, Universal, here acting on behalf of the producer, and Brad Pitt, the talent, not only risk a loss of a relationship with each other, but also with CAA.
5.3.3 The Production Transactions

The decision to undertake the production of a packaged project represents a major milestone and is referred to as greenlighting a movie. It is the decision to take a project as it has been developed and packaged up to that point all the way through production so that it can be delivered to distributors as a completed movie ready for exploitation. Hence, the production decision requires that one or more parties commit financing for the full production budget, and in that capacity these parties, which may be producers, distributors or third party financiers, play the decisive role in this important decision making process. In 2007, the average production cost of the 179 major studio movies release that year was USD 70.8 million (MPAA, 2008). Since development and packaging costs only represent about 10% of the total production cost, the production decision on the average 2007 studio-movie involved committing approximately USD 63.5 million to the project, an amount that underlines the gravity of the decision. The alternatives to a positive decision giving a movie greenlight are to either abandon the project or to endeavor to sell the project to another producer, known as putting a movie in turnaround. For the first alternative all investments made into it will be lost, while in the latter the loss will equal these investments less the turnaround acquisition price obtained (typically lower than the investments made). The ratio of developed and packaged projects to movies produced is somewhere between 20 or 10 to one (Dale, 1997; Finney, 2010).

The production financing transactions vary a great deal depending on sources and other factors, but are fundamentally dependent on the type of production-distribution contracting under which a project is carried out and will be discussed in the following chapter.

The production transactions consist of a large number of transactions through which the producer assembles all the resources necessary to complete the movie. They include the contracting of individual personnel, both creative (director, actors, photographers, designers, composers, digital artists, etc.) and technical (drivers, carpenters, electricians, caterers, etc.) and service companies, again both creative (special effects, visual effects, orchestras, etc.) and technical (equipment rental, hotels, transport, etc.).

The production process is typically split into pre-production, principal photography and post-production. Pre-production activities comprise all the detailed preparation and planning for the actual recording of the movie.
Creative decisions are finalized, casting and crewing is completed, sets and props are prepared, etc. (Clevé, 2006). During principal photography, all the scripted material is actually filmed in studios and on location, while post-production includes editing, looping, the application of music, visual effects and titles (Cones 1992). Historically, these stages have been quite strictly sequential but with new technology the degree of overlap is increasing (e.g. draft visual effects are prepared and shown in the camera monitor during photography to enable the real action to be better coordinated with the visual effects that will be finalized following principal photography).

However, using the same division into these three stages for the production transactions may not be particularly fruitful. First, many of the resources are contracted for more than one stage and there is thus no significant distinction in the contract between these stages. For instance, an actor is typically hired to render services in pre-production (rehearsals), production (main performances) and post-production (additional voice recording) (Farber, 2001a). Second, as discussed in more detail below, the overall variance with regard to the transaction dimensions is relatively modest.

Production transactions range from market to hierarchical types of transactions. With very few exceptions, only a few key positions on a movie production are covered by production company employees. The individual producer is often, though not always, a permanent production company employee (or partner), and the line-producer, an administrative position directly below the producer with the primary responsibility of ensuring that the production is completed on budget and schedule, may also be permanently employed by the production company. Everyone else are typically freelance workers hired on a project-to-project basis. Equally, most equipment and physical resources are hired on a project-to-project basis (Blair et al., 2003; Clevé, 2006). Furthermore, the production company will often set up a separate company, a special purpose vehicle (SPV), for each movie, so the freelance workers and service providers are not contracted directly by the production company, but by the SPV. The hiring and assembly of the project organization resemble market transactions in that individuals and services compete for jobs, and production companies compete for inputs based on price and quality. However, once hired and contracted, the project organization functions strictly hierarchically, with functional departments (camera, production design, sound, etc.), and with each department head reporting to the director on creative matters and to the
producer (via the line-producer) on administrative matters (Clevé, 2006). Individuals providing services on behalf of service companies will find themselves in a typical matrix project organization that follows both the project organization hierarchy and their permanent service company hierarchy.

Specific Investments

Again, as seen with the screenplay transaction from the narrow perspective of each production transaction, asset specificity is limited. Assets used in terms of cameras, lights, visual effects software, etc. are typically not specific to each transaction, but of a general purpose type, and in this view one may say, as Caves (2000) does, that asset specificity for motion picture production is generally low. But again, taking the project-oriented perspective changes the picture dramatically since the question then becomes to what degree investments are specific to a particular movie.

As with investments made into the screenplay transaction, those made into the production transactions are highly specific to the movie project, as they cannot be redeployed to any other movie project without a significant or total loss of value. Footage of a scene shot for one movie cannot be redeployed to others, with the exception of only very general footage of landscapes, etc. (so-called stock footage). Set designs constructed for one movie are generally worthless to others because, first, it will seldom fit the specific needs of other movies, and second, the storage costs until a new project comes along with those specific requirements would be prohibitive. Music created for one movie would in most cases not fit the dramatic and atmospheric requirements of another movie without significant rewriting and rearranging, and so forth. With costs to the producer of approximately USD 63.5 million for an average 2007 studio-movie, and with only a minor share of the output re-deployable, the production transactions represent significant transaction-specific investments toward a project’s production-distribution transaction.

Uncertainty

Similar to that discussed for the screenplay and packaging transactions above, there is significant performance uncertainty tied to the production transactions that involve creative components. The performance of the director, actors, photographers, designers, composers, editors and others is unknown until the work has actually been carried out. This uncertainty is
relevant both in view of each specific transaction and in the view of the production-distribution transaction.

The performance uncertainty is coupled with significant environmental uncertainty, typically in the form of unpredictable weather conditions when filming outside on locations. While skilled technicians can create substitutes for natural sunlight, rain, fog, etc., a change in weather conditions may still cause delays and force rescheduling to less optimal utilization of resources. Other types of environmental uncertainty may also cause delays, such as illness among personnel typically considered irreplaceable at this stage (the director and lead cast). Once a project has moved into pre-production, delays are particularly burdensome because substantial losses may incur if the process is halted (e.g. prepared sets and other construction may have to be torn down to give way for other productions, etc.). Other characteristics interplay with uncertainty, thus further amplifying the risks resulting from these uncertainties (Caves, 2000). The uniqueness of star talent, both in terms of popularity and artistic qualities, makes them less replaceable. The requirements of temporal coordination make such replacements difficult, even when replacements can be found. And finally, due to the multiplicative production function, the consequences of a less than optimal replacement may be severe for the entire project. Entering into pre-production is therefore usually seen as a point of no return for a production, which is also why a project typically needs to receive a greenlight for the complete production before entering this stage.

From the first day of principal photography the full cast and crew is hired, so the daily project turnover is therefore at its peak during this period. Delays in this process may result in total production costs running significantly over budget since the costs per day of operation are high. Thorough development and pre-production work may reduce the risk of running over budget during principal photography since many eventualities can be planned and prepared for (Putnam, 2004). However, due to performance uncertainty, unforeseen problems may be related to creative elements such as fulfilling the director’s vision. Any problems of this character pose a dilemma in that deciding not to spend additional money to complete the movie may diminish the value of the investments already made. Without taking the extra costs, one may not be able to complete a movie at all, or if so, only at an inferior quality-level. On the other hand, spending extra money may be “throwing good money after bad,” thus increasing the final losses. Two high-profile and relatively
extreme cases of movies going over budget during principal photography illustrate the dilemma: “Titanic” (1997, directed by James Cameron and financed by Twentieth Century Fox and Paramount Pictures) exceeded its original budget by approximately 80%, which made it one of the most expensive movies ever produced at the time of production. However, the decision to spend extra money turned out to pay off since the completed movie ended up as one of the most commercially successful movies ever at the box office (Madigan 1999; Petrikin 1999). “Heaven’s Gate” (1980, directed by Michael Cimino and financed by United Artists) also grossly exceeded its production budget to comply with the director’s vision while in the process of principal photography. But this movie turned out to be commercially unsuccessful despite the extra money spent, and the losses it inflicted on United Artists (a major studio at that time) eventually brought the company down (Bach 1985).

Upon completion of production, a master copy of the movie will be available for review and assessment. This leap in information available obviously greatly reduces the uncertainty related to the production-distribution transaction.

**Frequency**

As with the screenplay and packaging transactions, the frequency of the production transactions is generally low. While the variation is significant, most production companies do not produce more than a few movies each year. Additionally, different projects often require different skills, so some talent, crew and service providers fitting one project may not be suitable for others.

**5.4 Distribution Value Chain Activities and Transactions**

Distribution is defined by Cones (1992) as “the selling and licensing of a motion picture in various markets along with the advertising and promotion of the film.” Murphy (1995b) similarly defines it as the function involving the two primary interdependent activities of licensing and promotion. Compared with the categories of activities involved in the production function these two sets of distribution activities are less sequential in nature, and many activities from both occur concurrently.
5.4.1 Licensing Transactions

The licensing transactions are the transactions between the distributor and the various retailers/exhibitors for the exploitation of a movie. These are limited licenses under copyright that give the exhibitor the right to exploit a movie, but are restricted by territory, media and time. The licenses are granted in return for financial compensation known as film rental, which is usually determined as a percentage of the licensee’s earnings on a particular movie, but sometimes also in the form of a flat fee (known as outright sales in the industry, even though the transactions are not technically sales) (Cones, 1997; Farber, 2001a). Exhibitors include cinema operators, home video (DVD/Bluray) retailers, video-on-demand (VOD) service operators (such as Netflix) and TV channels. The licensing divisions of distribution companies, which handle these transactions, are typically referred to as distribution divisions in the industry, and licensing activities are usually referred to as distribution activities, but to avoid confusion with the overall distribution function of licensing and marketing and the production-distribution transaction, the licensing terms will be used here for both transactions and activities.

Licensing transactions and related activities for the theatrical market include sales to and negotiations with cinema-operators/licensees, determining the number of physical and/or digital prints or copies with which a movie will be released in theaters, the actual production and distribution of film prints/copies and other related materials to licensees and collecting film rental or license-fees. Furthermore, since the distributor’s compensation is typically determined as a function of the licensee’s revenues, the distributor will monitor the licensee’s exploitation of the movie to help curb opportunistic behavior such as licensees reporting too low sales and revenue-figures. For ancillary markets (including VOD, DVD/Bluray, pay-TV, free-TV and new media), the licensing transactions may be carried out by specialty licensing divisions for specific markets. Activities involved in
these transactions on the distributor’s side are primarily the negotiation of terms, the production and delivery of materials, and for some markets, the collection of contingent compensation (royalties).

Movies are licensed to be made available to consumers in different markets in succession, and this sequential marketing strategy is known in the industry as windowing (Hennig-Thurau, Henning, Sattler, Eggers, & Houston, 2007; Hennig-Thurau et al., 2006; Owen & Wildman, 1992). The theatrical market will have the first exclusive window lasting from three to six months from the premiere. A movie is then released in the home video market, typically first on DVD/Bluray and then on VOD-services, before it finally is made available for television broadcasts, first on pay-TV channels and then on free-TV channels. The price paid by a consumer will be highest in the first window and then gradually decrease in the following windows, with the purpose of this price discrimination being to maximize the revenues from any single movie.

Specific Investments
In terms of the licensing transactions, there is a degree of human asset specificity involved. Some of the specificity stems from experience with and knowledge of specific types of licensing transactions similar to what one would find in most transactions requiring skilled personnel, but it primarily comes from personal industry relationships. A distributor’s more senior and valuable licensing personnel will have built solid personal relationships with key personnel among the licensees within their specific area defined by media and territory. For instance, the distributor’s staff in its domestic theatrical distribution department will have strong relationships with the lead acquisition staff at the main cinema chains, and its staff in the international TV sales department will have similar relationships with acquisition executives at TV channels around the world. It follows that redeploying a licensing executive from domestic theatrical licensing to international licensing will decrease his or her value to the distributor. Investing in personnel with the proper and strong relationships thus represents a transaction specific investment, with the importance of such investments illustrated in the clip from a Variety report on new entrant distributors in Box 5.5.
However, in the project-oriented view of the production-distribution transaction, there are no or only negligible specific investments. A distribution executive may invite an acquisition executive for lunch to discuss a specific project, but beyond such petty investments there are none made in licensing transactions.

In terms of transaction-specific investments, the situation is therefore the opposite of that seen in the production process transactions, with low asset specificity for each production transaction, but high asset specificity in the project view of the production-distribution transaction. For the licensing transactions asset, specificity is higher in the narrow view of these transactions than in the project view.

**Uncertainty**
The uncertainty surrounding and integrated into licensing transactions are first and foremost tied to retail outlet access, and primarily so for the theatrical market. It originates from the interaction of performance uncertainty, behavioral uncertainty and sometimes environmental uncertainty as well.

**Box 5.5**
In 2007, the COO of the then newly established distribution company Overture, Danny Rosett, is interviewed by Variety about the company’s entrance into the market and asked about their distinct advantages (Hayes, 2007):

"For a startup, we have pretty impressive resources to put behind our movies."

When engaging in the physical rollout of films, a new entrant like Overture has to essentially sell a theater owner on relationships, probably even more than actual product. Rosett, for example, worked at United Artists; Peter Adee, who oversees marketing and distribution, is a veteran of four studios; and CEO Chris McGurk ran MGM after stints at Disney and Universal.

Robert Friedman, the longtime Paramount and Warner Bros. exec who runs Summit [another then newly established distributor] with Patrick Wachsberger, also isn't an unknown quantity to exhibitors. And he hired a well-regarded lieutenant, longtime AMC [a major cinema chain] vet Richie Fay.
For a theatrical release, the retail outlets – the cinema screens – are scarce. In 2007 there were 6,277 cinemas providing a total of 40,077 screens in the United States (MPAA, 2008). Release windows are limited to the 52 weekends in the year, and the total annual capacity is given by the number of screens for 52 weeks, which in 2007 gave 2,084,404 screen weeks. The same year, 603 movies were released, of which 179 came from the major studios (MPAA, 2008). Assuming for the sake of argument that these movies would be given 500 screens on average, the average theatrical run would be less than seven weeks. However, a wide movie release will usually occupy somewhere between 1,500 and 4,000 screens for the movie’s opening week, and successful movies have runs lasting much longer than seven weeks. According to imdb.com, Titanic (1997, directed by James Cameron and financed by Twentieth Century Fox and Paramount Pictures) had 40 weeks, with 22 of those playing on from 1,000 to more than 3,000 screens, while Avatar (2009, directed by James Cameron and financed by Twentieth Century Fox) had 46 weeks, with 14 of those on from 1,000 to more than 3,000 screens. The successes of these two movies were unusual, but it follows that even with much more modest successes, the competition between distributors to secure screens for their movies may be fierce. Many movies will struggle to achieve a theatrical release, and even if they do, they may be both limited to fewer screens and have their runs cut short if the performance does not meet expectations.

Cinema operators rely on ticket sales as their primary source of income (Redstone, 2006), and will be eager to terminate the engagement of a movie that does not fill enough seats and have it replaced by a new movie. Herein lays the performance and behavioral uncertainty. Even with a completed movie that can be reviewed (and a known marketing plan), it is difficult to predict its market performance (Caves, 2000). Furthermore, for the biggest budget projects, the so-called tentpole movies, the theatrical licensing transactions are commonly carried out even before the movie is produced. Hence, the ex ante performance uncertainty will be significant. Once the movie is completed and delivered, the opening weekend performance may fall short of expectations. Even if the value sharing provisions of the contracts are often structured to reduce the cinema operator’s risk (Redstone, 2006), poor market performance may trigger behavioral uncertainty in that the cinema operator will have strong incentives to prematurely terminate the movie’s engagement to open up capacity for other more successful movies.
playing in the market for which distributors are looking to expand the width of the release, or to other new movies for which distributors are still seeking additional screening capacity. Any such premature terminations will of course further reduce a movie’s ability to generate revenues since market access is lost. Finally, the time sensitivity of the release also leaves the transaction more exposed to environmental uncertainty. Bad weather in one or more of the major cities may prevent people from reaching the cinemas and thus affect the opening weekend performance. The movie has then lost an important window and will also rely on performing well the following weekend, but then in competition with a new slate of fresh product.

Box 5.6 provides an illustration of the uncertainty associated with theatrical licensing transactions.

**Box 5.6**

Early in the summer of 2008, the Los Angeles Times reported on issues facing distributors this peak season (Eller & Friedman, 2008):

*Tom Rothman and Jim Gianopulos may run a movie studio, but these days they often feel more like traffic cops, making sure 20th Century Fox's releases don't crash into rival films at the multiplex.*

*To help them through the congestion, the movie chiefs pore over slick white boards in their offices cluttered with color-coded magnetic strips showing the titles of films set for release through 2010. Like chess players in a high-stakes game, they shift films around hoping to outmaneuver rivals.*

*With a glut of titles flooding the marketplace, all studio bosses fear that the surplus is impeding an already rugged road to profitability. Studios and independent distributors last year released a record 517 films -- an average of 10 a weekend, up 49% from a decade earlier -- and this year movies are coming at the same pace.*

*"This is one of the biggest issues facing Hollywood today," said Rothman, noting that it's just as crucial to pick the right release dates for movies as it is to select the right script and hire the right stars and filmmakers. "When you're trying to cram too many movies into a finite number of release dates, it's inevitable some will suffer."* [...]

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Adding to their costs, movie companies spend huge sums to globally promote and release their films -- as much as $150 million for some big event pictures.

"In order to break through the clutter, we all feel the pressure to spend more in marketing," said Warner Bros. President Alan Horn. [...] 

Rarely is there a weekend when multiple movies aren't vying for screens and in many cases the same audience, especially during such peak moviegoing seasons as summer, fall and winter holidays.

This summer, Disney's much-anticipated sequel "The Chronicles of Narnia: Prince Caspian," got upstaged by two behemoths opening in proximity, "Iron Man" and "Indiana Jones and the Kingdom of the Crystal Skull."

"There were these giant vacuum cleaners on either side of us, and it took significant amounts of business away for our movie," said Walt Disney Studios Chairman Dick Cook. [...] 

Specialty distributors feel the pinch too. Not only are they spending more than ever on marketing -- a 44% jump last year to an average of $26 million per picture -- but in many cases their releases are getting booted off screens before being able to build word of mouth.

Fox Searchlight had high hopes for "Young at Heart," a feel-good documentary about a chorus of rock-singing seniors, when it was released two months ago to gushing reviews. But when it didn't immediately catch on, it got kicked out of Hollywood's Arclight Cinemas after just three weeks.

"Normally, we can hold them six to eight weeks," said Steve Gilula, who heads distribution at Fox Searchlight. "It's a jungle out there. If your gross isn't high enough, you're gone." 

Two of the summer's biggest star-driven comedies, Paramount Pictures' "The Love Guru," with Mike Myers, and Warner Bros.' "Get Smart," with Steve Carell, will open head-to-head June 20, much to the chagrin of the studios' respective movie chiefs.

For months, Hollywood executives had figured that either Paramount or Warner would blink, shifting to another date.

"I'm not happy about it, and Alan's not happy about it," said Paramount Chairman Brad Grey, referring to Warner's Horn. "But there was no place to go," given that every weekend of the summer had multiple movies or a potential
An amputated theatrical opening and release, or the worse-case scenario of failing to obtain a theatrical release at all, is likely to have grave negative effects on a movie’s overall revenue potential. Kevin Yoder, Co-COO at Los Angeles-based Nielsen NRG, a leading market research company in the motion picture area, says that “[t]he launch of a movie is like the end of a political campaign. If a candidate does not win on Tuesday, there is no Wednesday. In a movie campaign, if a movie does not perform strongly on the opening weekend, there is no second weekend” (Yoder, 2006). According to Yoder, the opening weekend affects all other revenue streams and ancillary markets. This industry thinking is supported by empirical research (Elberse & Eliashberg, 2003; Hennig-Thurau et al., 2006). Hennig-Thureau et al. (2006) show that short-term box office (the revenues generated by a movie during its opening weekend) affects the long-term box office (the revenues generated by a movie during the rest of its theatrical release), and that both short- and long-term box office affect home video (ancillary markets) revenues. They furthermore find that opening weekend results relate to the number of screens allocated to a movie in the second week of its theatrical run, and that long-term box office influences the width of the home video release in terms of the number of copies made available in the rental market. One may conclude that the risk following from the theatrical licensing transaction uncertainty is significant.

**Frequency**

A studio distributor release between approximately 15 and 30 movies theatrically each year, each requiring licensing transactions to be made with the cinema operators. Transaction frequency is therefore relatively high. For ancillary markets, the frequency is even higher since all theatrical movies are released here in addition to the movies that go directly to home video or television.
For each movie, however, frequency is very low since in most cases only one license transaction is made with each licensee to cover the full exploitation period. For ancillary markets, a license may be renewed or sold to a new licensee following the expiration of the initial license period, but the frequency is still low as the license period would typically be somewhere between five to 25 years.

5.4.2 Marketing Transactions
The marketing transactions include a number of transactions and related activities aimed at placing a movie in the markets and increasing its public awareness. Murphy (1995b) makes a distinction between three categories of marketing activities: Advertising, publicity and exploitation, and similar categories are used for the related transactions here.

Advertising Transactions
A distributor’s core advertising transactions involve the commissioning of creative work in the form of advertising materials such as posters, trailers, TV-spots and featurettes, as well as buying media time and space for and physically placing the advertising, typically through ad agencies and subcontractors. The first is handled by a distributor’s creative advertising department, while the latter is handled by its media department (Friedman, 2006).

Creative advertising does to some degree resemble the production process in that it involves the creative work of deciding on an overall advertising concept and strategy, and then producing the materials necessary for the various components of the advertising campaign. The most important components will typically be the trailers and so-called key art. Often, one or more short 30 to 90 second trailers (teaser trailers) will be prepared first and released as early as six months before the premiere, while the full length two minute trailers with more actual scenes will follow. The key art is images typically composed from a number of images from the movie which is then used for posters, print ads, DVD/Bluray-covers, etc. Depending on at what stage the production-distribution transaction is made and on what contracting type is used, as will be discussed in the next chapter, the creative advertising department may become involved as early as before the commencement of pre-production or as late as following the completion of post-production. The transactions may be fully integrated, with all creative advertising activities carried out in-house, or they may be of a market or hybrid kind,
with all the activities carried out by outside vendors specializing in movie marketing.

The media transactions in which advertising time and space are acquired are market based. Agencies specializing in each type of media are commonly used (Friedman, 2006). In 2007, the last year for which detailed numbers were made available, the major studios on average spent 21.6% of their advertising budgets on network television and 13.9% on spot TV compared to 10.1% and 4.4% on newspapers and online advertising respectively (MPAA, 2008). It is fair to assume that the online share has since increased. While most advertising for a movie is placed in the four weeks prior to its premiere, distributors will often purchase advertising capacity more than half a year ahead of peak seasons (such as summer) to secure access as well as fixed rates.

**Specific Investments**

In terms of the advertising transactions, asset specificity is mostly limited to human specificity. Skilled personnel are required for the creative advertising transactions, including also when these activities are outsourced, since the distributor will need to assess and supervise both the progress and quality of the work carried out and coordinate this with the distributors’ other marketing activities. Skilled personnel are also required for the media transactions as an intimate knowledge of each particular media is necessary to reduce uncertainty. For instance, the staff buying television time must be familiar with each channel or network’s practice of rescheduling programs so that the media plan can swiftly be adjusted accordingly, thereby avoiding reaching out to the wrong demographics.

In the project view of the production-distribution transaction, asset specificity is much greater and similar to that of the production transactions. Once resources have been invested into the creation of advertising material for a specific movie, they cannot be redeployed to another without a significant or total loss of value. And similarly to media transactions, once investments have been made into advertising space or time for one move they cannot ex post (after the advertising has run and the resources are converted into an increased awareness of the movie) be redeployed to another movie project. In 2007, the advertising investments on an average studio-distributed movie was USD 32.2 million (out of a total USD 35.9 million marketing investment), thus equaling almost half of the average
production investment, USD 70.8 million (MPAA, 2008). For movies with low or medium production budgets, the marketing investments may be equal to or even far exceed the production investments. “The Blair Witch Project” (1999, directed by Daniel Myrick and Eduardo Sanchez, financed by Haxan Films and Artisan Entertainment) provides an extreme example of this. The movie cost only USD 60,000 to produce, but according to two of the interviewees, it had a marketing budget close to the theatrical industry average of approximately USD 30 million when it was released in 1999 (MPAA, 2006). In the project view of the production-distribution transaction, the investments into production and advertising are actually quite similar with regard to both specificity and significance.

Uncertainty
The creative advertising transactions are also similar to production transactions in regards to performance uncertainty since they involve a creative element. However, it may be argued that since the advertising materials are based on already created production materials, they may be more easily redone if not considered adequate. This uncertainty is relevant in view of both the advertising transaction and the production-distribution transaction. However, in view of the latter, the advertising transactions will reduce the overall uncertainty as new layers of information are added (the nature and perceived quality of the creative advertising materials and the level of support from media buys).

Frequency
As with the licensing transactions, the advertising transactions have a relatively high frequency in terms of these transactions, but a low frequency in relation to the production-distribution transaction.

Publicity Transactions
The publicity transactions include the distributor’s efforts to obtain free media time/space by promoting news stories about a movie, interviews with its stars or other forms of editorial media coverage. Generally speaking, one may say that the media offers editorial coverage in exchange for content made attractive and easily available by the distributor’s publicity department. These transactions are thus supported by various forms of dedicated assets produced specifically for this purpose by the distributor. These include so-called electronic press kits (EPKs) that often consist of a behind-the-scenes program (approx. 30 minutes), a short featurette (3-7
minutes), a number of 60 to 90 second self contained stories that can be “wrapped around” by local newscasters (so-called news wraps) and a selection of location footage and movie excerpts that can be built into a bigger editorial piece (Friedman, 2006). The production of these EPKs are sometimes outsourced to specialized outside vendors, which are often the same companies used for creative advertising. Close to the release of the movie, the publicity department will also often arrange press junkets, in which both national and international print and broadcast journalists are flown to Los Angeles to interview stars and others involved in the making of the movie. Some publications like Vogue and Vanity Fair require exclusive photo shoots or interviews months before publication and must therefore be catered to specifically to achieve temporal coordination with the movie’s release. Apart from the outsourcing of EPK productions, the publicity work is generally carried out by the distributor’s in-house publicity department. However, the very first publicity activities that are carried out concurrent with the production of the movie may be carried out by a vendor contracted by the producer or the distributor, depending on the project’s production-distribution type of contracting. These vendors are so-called unit publicists and stills photographers. The first will write the production notes (a history of the filming), the biographies of key personnel and handle media requests for visits, while the latter will supply still photos (both on- and off-camera) to be utilized in later publicity work and possibly also in the key art for creative advertising.

Specific Investments
In view of the publicity transactions the asset specificity will be relatively low, with mostly specific investments required for skilled personnel.

In the project view of the production-distribution transaction, asset specificity will be higher as publicity for one movie cannot be redeployed to others. The magnitude of the specific investments made for publicity will vary. While the media time/space for publicity will always be free, investments required for the dedicated assets supporting the publicity transactions may reach several million dollars, particularly for EPKs, certain press junkets and special events (see Box 5.7).
Box 5.7

A Disney premiere and press junket for their 2001 release of Pearl Harbor, in which the press and guests were flown to Hawaii from North America and Europe, reached a total cost of more than $5 million. The event took place onboard a 97,000-ton Navy ship brought in from San Diego.

Variety (Ryan, 2001) reported that guests watched at sunset as eight Navy SEAL paratroopers jumped out of a Black Hawk helicopter from 5,000 feet above. All then stood in silence as four F-15 fighter jets from the Hawaii Air National Guard flew over the carrier in a "missing man" formation to honor the more than 2,400 Americans killed in the attack, which drew the United States into World War II.

The film was then shown. Disney made a one-of-a-kind print designed for the outdoor setting to guarantee state-of-the-art quality.

When the movie ended, a massive fireworks display lit up the harbor with a deafening finale that rained down sparkles on the memorial and the USS Missouri battleship nearby.

At the conclusion of the fireworks, elevators shuttled guests between parties on the flight deck and the hangar deck below.

The $5 million costs included $250,000 for catering, $100,000 for the orchestra alone and an undisclosed amount for insurance against damage to the ship.

"We're getting 10 times the cost of this thing in publicity," said Jerry Bruckheimer, the movie’s producer, and joked that "the next premiere will be on the moon" (Ryan, 2001).

The movie grossed $75 million from 3,200 screens in its domestic opening weekend, but dropped by 60% to $30 million from the same number of screens in its second weekend and ended up with a total of $199 million following its 16 week domestic theatrical run. Worldwide theatrical gross ended at $450 million. The movie’s production cost was estimated to $140 million (IMDbPro, 2011a).

Uncertainty and Frequency
Relying on editorial coverage will always imply a certain amount of uncertainty (Chen, Liu, & Zhang, 2012). The distributor will have no
guarantees as to the quality, favorability and amount of the editorial coverage, even though supplying publicity material such as EPKs will mean retaining control over certain elements of the coverage. Furthermore, the frequency of publicity transactions between distributor and each media will be relatively high, and this may be used by the distributor to award those who provide what the distributor sees as positive and helpful coverage.

*Exploitation Transactions*

The traditional third leg of movie marketing is exploitation - a label originally used as a catchall for what could not precisely fit under either advertising or publicity. However, it is primarily retained as a term to describe the modern phenomena of extensive merchandising such as videogame spin-offs, as is often seen on a large scale with movies like the Spider-Man and Harry Potter installments and Disney’s animated movies.

Generally, in the merchandising type of exploitation transactions, a movie’s title, icon or brand is translated to other products on an exclusive basis through limited licenses that grant access to the underlying rights in a particular movie to a manufacturer of specific goods and/or services in exchange for a royalty or fee (Ovadia, 2006). Due to scale economies in the production of consumer products, the license fee is sometimes formulated in gradually increasing steps tied to the product’s sales volume. These transactions are handled by a distributor’s *merchandising* or *consumer products* department.

Since the merchandising type of exploitation transactions cover a wide group of products and services, it follows that they are not integrated transactions. While market-like in terms of manufacturers competing for licenses on both quality and price (license fees), they are best described as hybrid transactions due to the extensive supervision and control required by the distributor, thus also adding governance costs (see Box 5.8).

In addition to the licensing fee, an important benefit to the distributor gained by these exploitation transactions is an increased awareness of the movie created by the store placements, marketing and sales of consumer products by the licensee. Without exploitation transactions, this particular awareness would be lost, so in order to achieve the same overall level of awareness the lack of exploitation transactions would have to be compensated for by additional investments in advertising and publicity transactions.
Other types of exploitation transactions are those of the brand placements and promotional tie-in types. A brand placement, often referred to as a product placement, is the inclusion of a branded product or brand identifier through audio and/or visual means in a movie, typically against a fee or a
promotional tie-in commitment (Karrh, 1998). In a promotional tie-in, the partnering company, often referred to as a movie’s promotional partner, agrees for a window of time to combine the focus of a movie with their services and product for mutual benefit (Ovadia, 2006). A promotional tie-in transaction may involve the partner’s commitment to spend a certain amount on advertising involving both their own product/service and the movie, and it may also involve promoting the movie in their stores and directly in relation to their products (see Box 5.9).

**Box 5.9**

Al Ovadia, executive vice president at Sony Pictures Consumer Products, describes promotional tie-in types of exploitation transactions based on their movie “Spider-Man” (2002, directed by Sam Raimi, financed by Sony Pictures and Marvel Enterprises) (Ovadia, 2006):

*Spider-Man had a number of promotional partners in the United States, such as Cingular, the wireless phone company; Carl’s Jr. and Hardee’s in the quick-service restaurant category; Kellogg’s; Dr Pepper; Reebok; and Hershey’s, all deals done by the theatrical global promotions group to generate awareness for the movie using somebody else’s media buys to supplement the studio’s marketing campaign. Television advertising by their partners featured their product along with Spider-Man for mutual benefit.*

[*] Kellogg’s brought media to the table in exchange for the ability to feature Spider-Man on a wide range of on-shelf exposure (cereal, Eggos, Pop-Tarts and Keebler Cookies), and they created advertising to support that; it was the advertising component that was key for our theatrical marketing group because, in a very crowded and competitive environment, we need that extra media to lift our property above the noise and clutter. In addition, there was separate license agreements [merchandising type exploitation transactions] made beyond the promotional exposure for a Kellogg’s Spider-Man branded cereal and for a Spider-Man branded Pop-Tart (blue and red, with webbed icing). The goal was to turn Spider-Man into an event. The studio spends its marketing dollars in telling a story; Kellogg’s uses its marketing dollars in building awareness.

[*] In what was perhaps a first, all in-store signage for Spider-Man carried the May 3 release date. Because the signage was up four to six weeks prior to release, this helped build tremendous awareness. The goal is to get a huge “share of voice” (in industry jargon) from our various partners so that their tie-in
Specific Investments
In view of the exploitation transactions, the distributor is making specific investments in terms of human asset specificity, similarly to that seen for the other types of distribution transactions.

Also in the project view of the production-distribution transaction, the specific investments required by the distributor will be low, but they will be more prominent on the licensee side of the transaction. Each consumer product requires the production of a prototype or master copy, and the licensee’s investments into these will be transaction specific. For video games, these investments may be several million dollars (and do as such resemble the movie production investments). Development costs for specific games are seldom published, but a study released in 2010 concluded that the average development cost was as high as USD 28 million for multiplatform games at that time and USD 10 million for a single platform game (Crossley, 2010), and larger movies may have multiplatform games among their mix of consumer products (Ovadia, 2006). For toys, specific investments will be lower but design and manufacturing retooling will be required, and for simpler products such as T-shirts they will obviously be low.

A promotional tie-in type of exploitation transaction will often involve advertising commitments from the promotional partner in the USD 5-20 million range per partner for TV domestic TV advertising alone, with quick-service restaurants predominantly representing the upper range, making them the distributors’ key target promotional partners. It is these media commitments which are the driving force from the distributor’s perspective since they complement the distributor’s own media buys, possibly also allowing the distributor to reduce its own media investments. Similarly to the distributor’s own media investments, these commitments represent transaction-specific investments from the promotional partner’s side.
Uncertainty
Since there will be creative components to the production of consumer products, there will be elements of uncertainty related to the quality of the final product. Hence, as illustrated in Box 5.8 above, the distributor applies hybrid transaction structures to secure supervision and control. This type of uncertainty is somewhat lower for promotional tie-in type of transactions since the creative production component is typically lighter. There will also be uncertainty related to the projected sales volume for consumer products, so hence royalty based compensation is commonly used. Another market-related uncertainty, particularly important from the licensee’s perspective, is related to the movie’s market performance. If a movie fails to attract the expected audience, there will be also less attention given to the consumer products and having carried the specific investments, which are sunk costs, the licensee risks incurring potentially substantial losses from the transaction. Additionally, this market uncertainty is lower for promotional tie-in transactions since the promotional partner will benefit directly from its media spend no matter how the movie performs, as its product is included in the advertising.

Frequency
As with the other distribution transactions, frequency is relatively high in view of the exploitation transactions. In view of the production-distribution transaction the frequency is low since only a limited number of exploitation transactions are made for each movie.

Other Transactions
Of the other marketing transactions in which a distributor engages the market research, transactions are probably the most important in terms of the production-distribution transaction. The goals of these transactions are to obtain consumer information that may help maximize the effect of advertising materials and general marketing for a movie and to provide the producers with constructive feedback (Yoder, 2006). While a distributor most often will have its own market research department that defines research needs and objectives, analyses results and provides the other distribution departments based upon such analysis, activities including drafting questioners and data collection are typically outsourced to a smaller number of outside research and consulting firms that specialize in consumer research for film and television. Since data needs to be collected nationwide to obtain representative results and since the collection method often
includes interviews and/or questionnaires in connection with screening materials, the outside consulting firms typically further subcontract at least part of the data collection activities.

The market research transactions typically cover a number of different types of studies. One is the research testing of advertising materials through intercept studies. This provides information about a movie’s *marketability* (how well a movie can be marketed and what movie elements are attracting an audience). This research typically starts a year to six months prior to a movie’s release. Another type is recruited-audience screenings, in which an audience is recruited based on target characteristics typically defined by the distributor’s market research department. If it is confident about a movie’s target audience, it may want to recruit a representative target audience’s key strengths to build and focus on in addition to the potential for word of mouth, or if they are less certain they may want to recruit a broader audience to help identify potential target groups or to see just how broad the appeal will be. These studies thus test the *playability* of a movie (how well it plays for an audience and how satisfied different segments of the audience are after seeing it). Recruited-audience screenings are sometimes also used for so-called *production screenings*, which are held while the movie is still in (post)production, with the objective to assess the strengths and weaknesses in the story and editing, and to identify elements that can still be refined. Distributors will also commission opening weekend exit surveys. These provide information about who went to see the movie, the audience’s satisfaction and hence the potential for a strong word-of-mouth and key media draws (what worked, what did not). Finally, so-called tracking surveys are carried out that measure awareness and interest in movies currently in release, about to be release or coming soon. This is a syndicate study for all distributors in which all distributors see the results for all movies in the study, helping each distributor gauge their movies’ competitive strengths (Finney, 2010; Yoder, 2006).

While the market research may be of great value to the distributor through synergy effects with other marketing transactions, the costs are relatively modest compared to its overall marketing expenditure. In terms of the market research transactions, the specific investments are limited to human asset specificity, which is also limited since much of the activities are outsourced.
In terms of the production-distribution transaction, the specific investments equal the costs of research carried out for the specific movie, but again, these costs are relatively low. As new layers of information are added in the form of information about a movie’s marketability, playability, tracking and exit polls, the uncertainty surrounding the production-distribution transaction is reduced.

### 5.5 Exhibition Value Chain Activities and Transactions

Exhibition activities and transactions are those following the distribution transactions still required to make a movie available for purchase by audiences through all retail channels, including cinema, home video, television and new media. Given the significance of the theatrical channel discussed in the previous sections, with its ripple effects on the other ancillary channels, it becomes an important element in understanding value creation and claiming among producers and distributors. It is in this respect that understanding exhibition sector activities and transactions is relevant here. Since the organization of neither distribution-exhibition transactions nor the exhibition transactions themselves are at the focus of this study, the following discussion will be brief.

Within the value system perspective, exhibition activities and transactions may be divided into categories of delivery and presentation, as shown in Figure 5.6 below.

![Figure 5.6 - The exhibition value chain](image)

### 5.5.1 Delivery Transactions

Delivery includes all activities required to get a movie from a distributor and making it available to the end-consumer. For theatrical exhibition (cinemas), that includes booking movies from distributors’ licensing departments, arranging for the physical or digital prints to arrive on time at the cinemas, advertise the booked movies in newspaper and other movie listings, and
often also placing marketing material for the movie inside the cinemas (Redstone, 2006). Most theatrical exhibitors own and operate a large number of cinemas and they typically have a centrally organized department that licenses the movies, while other activities are carried out at each cinema. While most transactions are integrated, some may be outsourced (shipping of materials, online ticket sales, etc.). In terms of value added for a specific movie project, the key output of the theatrical delivery transactions is booking the movie, and thereby actually making it available to the cinemagoing audience. Specific investments for any single movie are low. While an exhibitor will usually advertise for specific movies in connection with movie listings in the media, distributors will most often carry (at least some of) the media cost of such marketing investments by way of including so-called exhibitor allowances (sums granted as reimbursement for expenses) in their licensing agreements (Cones, 1997), the investments are therefore covered under the distributor’s media investments.

5.5.2 Presentation Transactions
Presentation covers activities and transactions that affect the quality of the consumer’s movie consumption experience. For the theatrical market, these include investing in technical and physical assets, securing a high picture and sound quality and providing a clean, comfortable and secure environment for the audience. From the specific movie perspective, these are important but non-specific assets, as they benefit each and every movie equally. Furthermore, in terms of value added for a specific movie, social aspects are also important. At the outset, the cinema offers a social environment for movie consumption where interaction between audience members is a natural part of the experience, both before and after the movie presentation (e.g. sharing expectations of the movie one is about to watch and other movies playing in the cinema before the show, as well as sharing opinions about the movie after seeing it). These social aspects, which may be enhanced by placing coffee houses, bars and restaurants inside the cinema complex or within its immediate surroundings, are generally more important for a movie release’s word-of-mouth diffusion effect than the social settings of the home video channels where movies are typically consumed alone or together with a narrower group of family and friends. Word-of-mouth, information shared between cinema-goers who have seen a movie and those who have not yet seen it, plays a key role in giving the theatrical channel its importance. De Vany and Walls (1999) conclude from their empirical study
of factors affecting a movie’s market performance that “the real star is the movie” (p. 285), meaning that it is the audience’s reaction to the movie as a whole, and their communication of such reactions, that determine a movie’s success rather than any single specific element such as star actor or director. With the more recent growth of social media, the impact from word-of-mouth is becoming even more important (Chakravarty, Liu, & Mazumdar, 2010).

5.6 Uncertainty

In the discussions of production, distribution and exhibition transactions above uncertainty has been uncovered in various forms, some generally applicable in the TCE literature and some more specific to the movie industry. For further discussions and analyses, it is helpful to categorize the most common types of uncertainty found in the context of movie industry transactions.

Starting with the generally applicable forms of uncertainty, behavioral uncertainty is the kind of strategic uncertainty that arise from opportunism (Klein et al., 1978; Williamson, 1985). In the above sections, we for instance recognize it in packaging transactions, in which talent may opt out of commitments ex post based on “contractual technicalities” such as screenplay approval, which may in some cases be similar to that described in Box 5.4, disguising the real objective of seeking termination. Another example may be seen in licensing agreements being terminated prematurely by cinema operators facing disappointing sales for a particular movie. The pure volume of transactions and the amount of these governing human behavior (talent/services) in a movie project expose it to opportunism and thus behavioral uncertainty. Environmental uncertainty, caused by outside disturbances, is also recognized. The situation described in Box 5.3 shows the impact of labor unrest and strikes, which are external to any particular movie project, and the discussion of production transactions covered the common exposure to weather disturbances with their potential ripple effects. Both types of uncertainties are present to a nontrivial degree and cannot be ignored.

However, there are more industry-specific types of uncertainties that may play a more important part for the transactions and investments of special concern. The first of these more specific categories are attributable to the
creative element embedded in many of the transactions and will be referred to as *performance uncertainty*. Unlike behavioral uncertainty, which springs from opportunism, performance uncertainty originates from bounded rationality. No matter how experienced, a writer, director or actor cannot accurately describe or guarantee the quality of the work or performance to be delivered. And the phenomenon goes beyond these obvious core creative inputs and applies to all inputs with a creative element, such as packaging (choosing talent appropriate for each task), creative advertising and publicity (choosing a publicity strategy or a spin on how to place a movie in the public’s awareness). These are *ex ante* forms of performance uncertainty related primarily to the delivering end in a transactional dyad. Drawing on Thompson’s (1967) terminology, the sum of all production transactions may be described as the motion picture production technology, and the essence of *ex ante* performance uncertainty is that this technology is far from *instrumentally perfect*, meaning that the production transactions often do not produce the desired outcome. Similarly, but to a lesser degree, the motion picture distribution technology is also instrumentally imperfect and thus subject to *ex ante* performance uncertainty.

The *ex post* form of performance uncertainty comes from the inherent difficulty of assessing the quality of creative work. So even after a screenplay is written or an actor’s performance is delivered it may be difficult to objectively and accurately assess the nature and qualities of the work. Even after the market has granted a creative product success, it can seldom be explained by the satisfaction of some preexisting need (Caves, 2000). This phenomenon also goes beyond the core creative elements and applies to transactions with less obvious creative elements, such as the entertainment press’ perception and valuation of a publicity event. This *ex post* form of performance uncertainty is primarily associated with the receiving end in a transactional dyad. In the transactions studied here, there will typically be elements of both *ex ante* and *ex post* performance uncertainty, and there will hence be situations with certain degrees of both *ex ante* and *ex post* symmetrical ignorance. For instance, upon commissioning a screenplay, neither the writer nor the producer will know the quality of the work to be delivered, and even when completed and delivered, both parties may face difficulties accurately assessing the quality of the work.
A closely related type of uncertainty, which may nevertheless benefit from being separated, is the uncertainty related specifically to the form of a creative product, which will be referred to as product uncertainty. Unlike performance uncertainty, it does not relate to the valuation of a product or service, only to its nature and form. Consequently, there will be product uncertainty related to a screenplay until it is written, but once it is done this particular form of uncertainty will be eliminated. The hybrid type of screenplay transactions therefore involve product uncertainty, while this particular form of uncertainty is absent from the acquisition type of transactions. Moving downstream through the value system with a project, there will be product uncertainty related to the movie itself until post production is completed with the creation of a master copy, at which point that particular product uncertainty will be eliminated.

Finally, in the discussions of the distribution transactions, a special type of uncertainty may be recognized in terms of a movie’s access to the various market channels (including exploitation channels), which will be referred to as channel uncertainty. A competitive theatrical market does not allow all movies a release of the scope its producers and distributors would ideally seek and in some cases no run in the cinemas at all. Access to ancillary markets and the scope of the releases are further dependent on a movie’s theatrical performance, which in turn is dependent on its opening weekend performance. These are factors creating channel uncertainty for which distributors must seek safeguards, such as contracting cinemas early (Fritz, 2012) and employing personnel with strong relationships among exhibitors. As shown in Box 5.6, strategic behavior among competing distributors also adds to channel uncertainty.

Each type of uncertainty does not of course exist in a vacuum, so interactions and overlapping types of uncertainty affecting transactions is the norm. For example, most transactions made under performance uncertainty will also be subject to behavioral uncertainty. A writer behaving opportunistically in the way of not putting sufficient resources into the work to achieve a good result may take cover under performance uncertainty if criticized by the commissioning producer. With such ambiguity, contractual safeguards may be difficult to enforce and would in this particular case be limited to language on “best efforts” and “industry standards” (Farber, 2001a). Another type of interaction will be when efforts to reduce one type of uncertainty trigger other types. For instance, a distributor investing in staff
with strong relationships to exhibitors (human asset specificity) to reduce channel uncertainty will by doing so increase its exposure to opportunistic behavior and behavioral uncertainty, as specialized staff members will be more difficult to replace. Safeguarding may thus involve such tradeoff considerations.

Finally, as a movie project moves downstream through the various production, distribution and exhibition transactions, the information about its nature and quality is revealed gradually. The product and performance uncertainty related to the movie will therefore be greatest for the early transactions (development) and lowest for the latest (delivery) transactions, with the implication for the production-distribution transaction being that the producer will generally face greater uncertainty than the distributor.

5.7 Asset Specificity

As discussed in various sections of this chapter above, as well as in Section 4.4, the understanding of asset specificity entirely depends on the specific transaction to which the assets are deemed specific or nonspecific, and the context within which that transaction is seen also matters. The transaction of primary interest here is that between producer and distributor for a movie project, so it is a transaction between producer and distributor in the context of a movie project. This context is illustrated in Figure 5.1 above. A movie project may be seen as one complex transaction divided into three stages of production, distribution and exhibition, and as shown in this chapter each of these stages consists of numerous micro-level transactions and activities. The production-distribution transaction is thus one between two stages incorporated into a more complex transaction.

It follows that within the context of one complex transaction, asset specificity may be defined in a number of ways depending on which stages and what levels of detail one is concentrating on. As shown in previous sections asset specificity may be defined as slight in terms of the lower levels, but still as high in terms of the top project level, or vice versa as in the case of licensing transactions. Hence, context matters and asset specificity would appear to be different if the transaction was stripped of this context as in Figure 5.7 below.
It should be noted that contextualizing the production-distribution transaction in a more complex project transaction, with increased levels of asset specificity as a result, may by itself increase expectations of finding vertical integration. Klein et al. (1978) note on the complexity of transactions: “[T]he costs of contractually specifying all important elements of quality varies considerably by type of asset. For some assets it may be essentially impossible to effectively specify all elements of quality and therefore vertical integration is more likely” (p. 301). Yet, as we shall see, market-type acquisition contracting is frequently used for production-distribution transactions.

Since it is the asset specificity at the top project level, originating from project-specific production-distribution investments, which is the main concern of this study, it is helpful to clearly categorize this specific type of asset specificity. The terms project specificity and project-specific investments will be used for reference to these types of asset specificity and transaction specific investments, respectively. These terms will allow us to more precisely and specifically discuss asset specificity in a project context. Other asset specificity concepts have been developed from case studies on projects in earlier research, but none that capture this specific feature. Masten et al. (1991) presented the concept of temporal specificity based on a case study of shipbuilding. It refers to the temporal coordination problem of replacing nonspecific assets required for a transaction in a setting where time is of the essence and tasks must be strictly ordered for work to proceed. So even if these assets are nonspecific at the outset, the temporal coordination issue causes them to expose one transaction partner to opportunistic behavior from the other in ways similar to transaction specific assets. When deciding on a governance structure they should therefore be regarded as being similar to transaction-specific assets. Building on the concept of temporal specificity, Chang and Ive (2007) introduce the term process specificity in a case study of the Channel Tunnel construction between France and England to help capture clients’ exposure to opportunism from contractors in the case.
of ex post specification changes to a contract. Again, these are different features than those captured by project specificity. Project specificity refers to specific assets supporting a complex transaction (a project) that can be broken down into two or more stages, and while assets may not be deemed specific to transactions between these stages, they still represent the project specificity type of asset specificity if they are specific to the contextual complex transaction (the project). And as with any type of asset specificity, there is not necessarily a question of an asset being specific or nonspecific, but to what degree it is specific.

Much of the micro-level transactions carried out by producer and distributor, respectively, with third parties or internally is for the very purpose of creating assets specific to the production-distribution stage of the project transaction. The producer’s investments into concepts and screenplays, talent commitments and finally production are largely non-salvageable outside the context of the specific movie. Similarly, the distributor’s investments into the production of creative advertising and its media buys, which represent the bulk of its marketing investments into a project, are also nonsalvageable outside the movie-specific context. With 2007 figures showing a combined average production and marketing cost per major studio movie project of more than USD 100 million, and almost USD 75 million for the so-called specialty movies (MPAA, 2008), it follows that asset specificity in the form of project specificity is high in both relative and absolute terms.

The combination of high project specificity and significant uncertainty makes the required production and distribution investments risky. The episode referred to in Box 5.3 illustrates the risk, in this case for development. Due to environmental uncertainty and the demand of temporal coordination (similar to temporal specificity except the assets in questions here were not nonspecific), the project had to be abandoned. It follows that the investments made in development and preproduction are largely written off and lost. Similarly, if a project is abandoned at a later stage or underperforms at the box office, project-specific investments into production and distribution may be lost. Tom, COO at a major studio, sums it up: “[A]ll of the money you expend, whether negative [production] or P&A [distribution], is money at risk”.

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When moving on to the contracting between producer and distributor in the next chapter, important implications are that significant project-specific investments are required of both contracting parties, and furthermore that these investments are made sequentially with most of the production-related investments generally required before the distribution-related investments. Since product- and performance uncertainty are gradually reduced as the project moves forward, this also means that production investments are generally riskier than distribution investments. Ryan, marketing and distribution executive at a larger independent production company, describes production as “a high-risk business with lots of money involved.” Consequently, as it will be shown in the following chapter, the high risk turns the financing of distribution and particularly production investments into a challenge for both transaction parties.
6 Production-Distribution Transactions

Within the context set forth in the previous chapter, this chapter will provide a detailed description and within-case analysis, based on interviews and documentation, of the contracting cases for transactions between producers and distributors that were only briefly outlined in Chapter 4. It starts with a discussion of the horizontal cases of all rights and split rights deals, which later and in more detail are applied to each of the vertical cases. The vertical cases of acquisition and output contracting (see Figure 4.1) are each broken down into sub-cases of its most common forms for a more detailed analysis. Finally, layered contracting combining two or more of the sub-cases in vertical chains within a single project is discussed. Together with the previous chapter, this chapter will provide the basis for discussions of the empirical findings on relationships between structure and investments, which will be covered in the following chapter.

6.1 All Rights and Split Rights Contracting

Along the horizontal dimension of transactions between producers and distributors, two cases are defined in Chapter 4 that in effect catch all transactions. The first, all rights contracting, refers to transactions in which one single distributor is assigned all distribution and exploitation rights to a project from the producer (see Figure 6.1A). The second, split rights contracting, covers all transactions in which distribution and exploitation rights to a single movie are assigned from the producer to two or more distributors (see Figure 6.1B). The first contracting mode is simple in that it involves one producer and one distributor, while the latter may be more complex when distribution rights are split between several distributors from the producer’s hand.

![Figure 6.1A](image1.png)  ![Figure 6.1B](image2.png)  ![Figure 6.1 C](image3.png)
Generally, in split rights contracting, distribution rights are split along media and/or territory. As we shall see in the following sections, one quite common structure based on a territorial split is that one distributor contracts with a producer for all domestic rights, while others (one or more) contract for international rights. Rights may furthermore be split between media within a territory. A producer may for instance have a contract with a domestic pay-TV operator, whereby the pay-TV operator pays a pre-negotiated compensation, sometimes expressed as a function of each movie’s box office gross, for all movies produced and delivered by the producer. Pay-TV rights would therefore have to be excluded from any other contract the producer makes with a domestic distributor, and the producer’s movies will thus all be subject to split rights contracting (see Lyons and Goldsmith (2000) and Lyons (2001) for an example). It could also be argued that rights may be split according to time, so that for example one domestic distributor is assigned all domestic rights for an initial 15 year period, and when this agreement expires the producer may contract a different distributor. However, in production-distribution contracting, distribution rights are most often contracted in perpetuity (Cones, 1997), and because we are primarily concerned with the contracting and joint value creation taking place for the production and initial release of a movie, this longitudinal perspective is of less importance than splitting according to media and/or territory.

When split rights contracting is applied to a project, each distributor will carry out the distribution transactions within the limits of its territory and/or media. If a movie is contracted with one distributor in the US and another in the UK, the joint value creation in each of these territories will be different dependent on how each distributor chooses to carry out their distribution transactions. The UK distributor may for example choose to profile the movie differently than the US distributor by taking a different approach in its creative advertising and publicity transaction. Due to these differences, the joint product created by producer and each distributor, which may be best described as the movie’s image (see Table 1.1), will not be the same in both territories. Sometimes under split rights deals the image will vary from one territory to another due to differences in how each distributor sees and approaches a movie; as a result, the movie may perform poorly in one territory while becoming a significant success in another. An example is provided in Box 6.1.
Under all rights, contracting a distributor controlling a movie in all media worldwide may of course also choose to adjust its image to local tastes. The key difference between this and the split rights situation is that here the adaptations are made and coordinated within the hierarchy of a distribution firm, and the origin for territorial adaptation will not be variations in the marketing strategies chosen by different distributors, but the result of a marketing strategy chosen by one distributor that is subsequently adapted to local conditions. An example is provided in Box 6.2.

Since each distributor under split rights contracting for a movie will carry out its own distribution transactions, there will also be a separate revenue stream created by each distributor as a basis for joint value claiming by producer and distributors. There will be no horizontal interlinking of these revenue streams. The UK distributor referred to in Box 6.1 will not benefit from the success of the US distributor. The cross-collateralization of these revenue streams can only take place once they reach the producer.
Box 6.3

Emilie, marketing executive at a major studio, explains the difference between so-called one-pot (or in-the-pot) and two-pot horizontal co-production deals:

In this day and age you see a lot of situations where studios are sharing projects. You’re seeing more and more... Again, many times, what the financial deal is between studios is: we’ll have domestic, they’ll have foreign. But it’s 50-50. For every dollar I make they get 50 cents and every dollar they make I’ll get the same. And we split our costs. So a lot of them are “in the pot”-deals, we call them. And then occasionally you have a [two-pot] deal where you pay your P&A, they pay theirs, what they make they keep and what we make we keep. But I think that’s more unusual on those shared studio deals.

Emilie, President Domestic Marketing, major studio

Box 6.2

Ryan, marketing and distribution executive at an independent production company, uses the movie “Pearl Harbor” (2001, directed by Michael Bay), which was distributed by Disney/Buena Vista throughout the world (and not produced by his company), to illustrate how projects are successfully adapted to local tastes:

Take for example “Pearl Harbor”, the campaign in Japan was changed considerably. The movie-going public is made up substantially of young females, secretaries, young single girls... they make up a substantial majority of the Japanese movie-going audience. So they turned “Pearl Harbor”, instead of an action picture or as Pearl Harbor historic... they made it into a love story and they sold it as if it was a love story really. They sold it as a triangle of a three - a love story and the movie was smash huge hit there. And it outperformed in Japan and sold better than in any other part of the world. Or if you take the movie into Korea or Taiwan, the thing you’re gonna show on the one-sheet [artwork used for posters, ads, DVD-covers, etc.] is explosions, action, planes crashing, ok... cause those are historically very action oriented male dominated audiences.

Ryan, President Worldwide Marketing & Distribution, independent production
Finally, a division of distribution rights may be initiated by a distributor that at the outset has contracted all distribution rights from a producer. Instead of exploiting all distribution rights, the distributor may choose to bring in a second distributor for the exploitation of certain rights against committing to some form of joint value creation (see Figure 6.1C). This is not defined here as a separate horizontal case since it is a structure initiated between distributors, and not between the producer and distributor. However, it is included to show how an all rights production-distribution transaction may end up with distribution rights split between distributors and with other elements of the structure also resembling split rights contracting. A typical case would be that there is an all rights vertical contract between producer and distributor, whereby the distributor is committed to financing not only its distribution transactions but also the production transactions. By bringing in a second distributor that takes all foreign rights, the initial distributor would not only avoid having to carry the investments for foreign distribution transactions, but the second distributor would normally also be required to cover half the production transaction investments. Consequently, in the industry these horizontal transactions are usually referred to as studio co-production deals, even though it may be argued that they initially and primarily are co-distribution contracts. Here, it will be referred to as horizontal co-production contracting. Depending on how value creation and value claiming are structured between the distributors these may be sub-categorized as either so-called one-pot or two-pot contracts, which is explained in Box 6.3 above. In many ways, the two-pot contracts in particular will resemble split rights situations in that each distributor contributes to value creation by carrying only its own distribution investments, and that value claiming is based only on its own distribution-and exploitation rights.

6.2 Acquisition Contracting

Turning to the vertical dimension of transactions between producers and distributors, acquisition contracting represents the transaction mode closest to market contracting. Generally, under this mode the producer initiates the movie project without having the distributor contracted and the distributor later acquires the movie from the producer for distribution in its territories and media. Tom, COO at a major studio, provides a brief description of their typical acquisitions:
There are straight acquisition deals where we go out and buy another company’s product, so that they will have made a movie and are looking for a distributor. They would say to us: “We’ve just finished this picture, we’ve paid for it, would you like to distribute it?” And our people will go and look at it. And it is usually representatives from distribution [licensing], from marketing, from international, from home video. They would look at this and say, “You know we really like this movie and we think we should distribute this movie.” And I would say to them “ok.” And the way to do that would be either we buy the movie in what’s called an outright negative pickup, we just buy it. “Say, how much money do you have in the movie?” “We’ve spent 30 million dollars on it, but we want 35 to buy it.” “Ok, here is 35 million dollars.” Or – they would say: “We’ve paid for it, we keep the rights, we own it, you distribute it, but because we have taken the risk of development, taken the risk of making the movie in the first place, and because we have taken the all important negative [meaning production] risk to finance the movie, we expect a low distribution fee, not your typical contractual fee of 30% domestic theatrical, for example, but we want it to be less than 15%, we want it to be 12.5%.” Then I might say yes and I might say no. When we say 12.5% that would be in all markets, ok. And so we will just distribute it in all media throughout the world if we can get these rights. Sometimes they would say: “We have international investors, all rights are available...” – this is more common – “all domestic theatrical rights... or all domestic rights so we want you to give us, our picture cost 30 million dollars, we would like you to give us 40% of that number or 12 million dollars for all domestic rights and distribute for 15%.” Or 17.5% or 20%... And [our] business affair people make that kind of deals.

Tom, COO, major studio

The first scenario Tom describes, in which he refers to a flat acquisition price, is one common form of acquisition contracting, outright negative pickup deals, a term he also uses to describe it. In the industry, this form is also sometimes referred to as just pure acquisitions (Cones, 1992). The second scenario, in which he refers to the percentage distribution fee, is the other standard from, often referred to as an acquisition distribution deal (Cones, 1992; Farber, 2001a). And he speaks of both of these as all rights
deals, meaning that the distributor, his studio, acquires rights to all media throughout the world. His final scenario is a variation of the acquisition distribution deal, in which the compensation paid to the producer is a fixed advance against a percentage distribution fee, and this is also a split rights deal in which his studio only acquires the distribution rights to all media in North America, while others (the international investors) retain distribution rights to foreign territories. While acquisition contracting is, as we shall see, common and often associated with lower budgeted movies, it is not uncommon also among bigger budgeted movies released by major studios. In 2005, for instance, six of the 18 movies released by Universal, a major studio distributor, were acquisition-contracted movies (Snyder, 2005).

6.2.1 Outright Negative Pickup Deals

The term negative pickup is old and refers to the acquiring distributor picking up the physical negative prints – the film rolls – of a completed movie (Cones, 1992), and it illustrates the market-like nature of these transactions. Simplified, the producer negotiates a price for the finished movie with target distributors, with the distributor putting forward the best offer then making the payment and picking up the finished product.

The events and venues where much of these transactions take place also reflect their market-like nature. These are annual film festivals and markets where producers show their brand new movies for the first time to festival audiences and among them, distributors’ acquisition executives. The Sundance Film Festival (January) and Toronto Film Festival (September) are considered among the most important festivals for domestic acquisition and the Berlin Film Festival (February) and Cannes Film Festival (May) for international distributors. The key markets are Berlin and Cannes (conjoint with the festivals), as well as the American Film Market in Santa Monica, CA (November). Examples of festival-based acquisitions are provided in Box 6.4.
Box 6.4

Variety reports from the 2010 Sundance film festival in Park City, Utah (McClintock, 2010a):

After nearly 72 hours of negotiations, Focus Features [a subsidiary/specialty division of major studio Universal] closed the biggest deal of the Sundance Film Festival late Thursday, paying $4.8 million to distribute Lisa Cholodenko’s "The Kids Are All Right" in the U.S., U.K., Germany and South Africa. [...] While Focus was hammering out the terms of its pact, two other distribution deals closed early Thursday, all contributing to the busiest festival in recent memory in terms of acquisitions, whether Sundance, Toronto or Cannes.

Publisher Hannover House's film and homevid arm picked up domestic distribution rights to Joel Schumacher's dark teen chiller "Twelve" for around $2 million. Film hadn’t even made its public debut when the pact was inked. "Twelve" is Sundance's official closing-night film, and unspools tomorrow night at the Eccles theater.

Spencer Susser's "Hesher" also found a home, with Newmarket plunking down around $1 million for U.S. distrib rights. A Canadian deal for the pic is currently closing.

"Hesher" premiered here last week to mixed industry reaction, but has been a crowdpleaser. Film stars Joseph Gordon-Levitt as a mayhem-prone loner who takes up with a family still reeling from a death. Pic also features Devin Brochu, Natalie Portman and Rainn Wilson.

Earlier in the week, Lionsgate swooped in and paid $3.2 million to distribute Ryan Reynolds thriller "Buried" in the U.S. Repped by UTA's Independent Film Group, pricetag for "Buried" was comparable to "Kids" in terms of domestic rights, insiders say.

Indie execs say they are heartened by the number of distribution deals coming out of Sundance, considering how quiet the fest circuit has been.

Focus Features CEO James Schamus told Variety that there are always shakeout periods.

"We went through an insane market glut where there was too much product. Films failed and got lost in the shuffle," Schamus said. "But there are very smart
dealmakers out there, and new filmmakers coming up all the time. I'm optimistic."

Focus did not say in which quarter of 2010 it would release "Kids." It is Focus’ first festival acquisition since "Hamlet 2," which the company picked up for $10 million two years ago at Sundance.

The following, reported one day earlier, offers more detail on the “Kids” acquisition (McClintock, 2010b):

Sundance dealmaking looked to be coming to a head Wednesday, with Focus Features in the home stretch to win North American rights to Lisa Cholodenko’s lesbian parenting comedy "The Kids Are All Right," starring Annette Bening and Julianne Moore.

Deal figure hovered around $5 million, with the final tally depending on the overseas territory rights that Focus will snag as part of the package. They included the U.K., Germany and South Africa.

Cinetic brokered the domestic sale, while Inferno is handling foreign sales on the pic.

Pact was nearly two days in the making after the film's raucous Sundance premiere on Monday night. Among the other parties making a run for the film were [distributors] Fox Searchlight, Summit, Sony Classics and the Weinstein Co.

Bening and Moore star as moms of a daughter ("Alice in Wonderland's" Mia Wasikowska) and a son (Josh Hutcherson) who seek out the sperm donor (Mark Ruffalo) who fathered the kids. Screenplay was co-written by Cholodenko and Stuart Blumberg.

Film played like gangbusters at the Library Center premiere, with lots of laughs and sniffles from the aud.

Virtually every indie distrib and studio specialty buyer was at the screening, including Summit's Rob Friedman and TWC's Harvey Weinstein. Introducing the film, fest chief John Cooper noted that if something bad were to happen at the venue that night, "there goes the independent film industry!"

"Kids" unspooled in the fest's Premiere section, which usually features films that have high-profile casts.
At these events the producers (sellers) present their movies (product) to distributors (buyers). Since the top festivals attract the most buyers, they are also the most competitive in terms of getting a movie accepted and included in one of the official programs/sections. Being able to pick and fill the programs with the most interesting movies, the top festivals thus reduce the distributors’ search costs in a similar way, as a good literary agent reduces a producer’s search costs when looking for concepts and screenplays. The continuing top informal rating of a festival is therefore dependent on its ability to choose and deliver interesting movies for the distributors’ acquisition executives every year. Producers who fail to gain acceptance for a movie at these festivals may take it to one of the markets that are open to all movies. Lower profile festivals are often of limited value since few if any buyers attend. But buyers do attend markets since there will typically be attractive movies put forward that they do not want to miss, even if the majority of movies on offer may be deemed uninteresting. Markets are also the preferred venue for movies that do not naturally fit any top festival due to genre or style. At the markets the producer, or its sales agent, can purchase screening slots at market cinemas and invite buyers to see it. Sometimes producers engage two sales agencies, one to represent the movie towards domestic distributors and another to work towards foreign distributors (as in Box 6.4 “Kids” was represented by Cinetic and Inferno for domestic and foreign sales, respectively). Sales agencies are typically specialized towards either domestic or foreign sales with significant human asset specificity in the form of sales executives, with strong relationships to either domestic or foreign distributors’ acquisition executives.

As shown in Box 6.4, there will typically be bidding situations for attractive product that determine which distributor gets the movie. Considering the performance uncertainty related to the ultimate performance of any movie among audiences, the highest bidder in these acquisition markets sometimes overpays. Jennifer, marketing executive at a major studio specialty division, comments:

At the preem, Cholodenko said the pic was many years in the making, but that it was a push to ready the film for Sundance. "We did rush to get it over here," she told the crowd.
Jennifer: And at the festivals [the producers] often try to create a bidding circumstance where... you know, they take [the movie] to a festival because they hope that everyone will see it in one room and that a lot of people will be interested, and then you get nervous somebody else will get it before you and you’ll overpay. So that’s what they’re hoping.

TG: And those things happen a lot?

Jennifer: It used to happen more than it did... and then there were high profile cases of people paying way too much... I guess one of the examples everyone always brings up is this one called “Happy Texas” and Miramax [a mini-major distributor] paid, I don’t know, something like five million for domestic rights, and then it just... they didn’t get anything going. Cause there becomes the festival fever, because at the festivals you often see a series of movies that aren’t that promising and then when you see one that actually has something it appears better there than it would in your own screening room. Cause it’s like bad, bad, bad, bad... Oh, that’s fine, that one is really good. So then you start to get excited and then it gets competitive because you don’t want somebody else to win over you. But I think most people are savvy about that now and people really don’t want to get burned so people take a deep breath and say: “Do I really want this, what can we really do with it, how much can we really make or am I just getting excited because I don’t want them across the room to get it?” I think people are smarter about that now.

Jennifer, President Marketing, major studio specialty division

While most outright negative pickup deals are made at a stage in which production is completed so that the full movie can be shown at a festival or market, they may also occur at earlier stages. Sometimes, producers will sell a movie “off a product reel” (Thompson & Siegel, 2008), which means that while the movie is in production the producer will cut together a short sequence from the scenes that have been shot and show it to distributors. They will then assess the project based on the reel, as well as the package of screenplay, director, actors and other talent. The deal may also be made as
early as prior to the commencement of production (Cones, 1992, 1997), but while this is not uncommon for deals with international distributors (and is then referred to as *presales*) it is rarer for domestic theatrical or all rights deals. A deal closed before production will of course entirely depend on the project’s package, and obviously they are made either at markets or by producers approaching distributors for the movie specifically between markets and not at festivals.

The reason and motivation for closing a deal before the completion of production may vary, but the competitiveness of the acquisition market at any given time will often play a role. Ryan, marketing and distribution executive at a larger independent production company who also has extensive experience with major studio distribution companies, explains:

*Ryan: [A distributor acquires early] because if they don’t somebody else will. And to remain competitive you have to get involved into the movies at earlier stages. Cause if you think... If it’s a really interesting script, with good elements, the right director and the right money, chances are someone’s gonna buy it as a pre-buy. And if you sit there and wanna wait until the movie’s done, that’s fine, assuming no one else has bought it. So it’s always the question of if someone else’s gonna buy it or at what stage they are gonna buy it. I mean obviously, as I always used to say “I would rather pay more for a movie and watch it”.  

TG: Right, as a distributor.

*Ryan: Yes, as a potential distributor. Like, yeah, I’ll pay five dollars on the script stage. But I would rather pay, if I liked it, seven dollars after having watched it and know that I made a right decision. I’d rather pay more for the privilege of watching it than prematurely having to saying yes or no.

Ryan, President Worldwide Marketing & Distribution, independent production company

So doing a deal before the production is completed increases the buyer’s risk since product and performance uncertainty will be significantly higher and some, like Ryan, would then from a distributor’s perspective prefer instead to pay a higher price than to take the additional risk. However, from the
producer’s perspective the argument may of course be the opposite. From his current producer’s perspective Ryan prefers to make the deals before going into production:

**Ryan:** Ideally, in the ideal world you wanna try... Well, there is couple of ways of doing it. One, you want to... The most common way, the most common time that this is done is when you have a script that you’re thinking is ready to shoot, you’ve attached a director and you’ve attached a primary cast. You have an approved budget and you have hopefully a start date for the picture and you have all the talent ready to go. Then at that particular time you want to start approach the distributors to sell the picture for a particular territory or territories.

**TG:** Why is it that you want to do it then rather than when you have finished the movie?

**Ryan:** Well, because when you screen the movie that is done..., what you’re doing in the pre-sale situation is you’re hopefully giving a buyer, you say: “Read this script, imagine... here’s who is in it and they are playing these particular parts.” You’ve got the director and what you are basically doing; you’re trying to paint an image. You are trying to... You’re selling the picture to them. What you’re trying to do is peak their interest and peak an emotion. And at the same time, give them a reason why they have to have this movie. And also on paper you’re reading a script and at the same time the buyer is thinking “who would the four quadrants, who are the demographics to the movie? Who’s gonna see this picture? How am I as the distributor gonna sell the picture? What is the marketing? What am I selling?” [...] And it’s a pre-sale, so the movie is not done. [...] You’re reviewing all this in your head. Then it is selling it there. If you sell a movie when it’s done, so people come to the screening and they sit down and at that time, there’s nothing you can do. It’s screening. You’re watching it. And this is the movie. There’s nothing you can really do to massage it or kind of use their sixth sense really or use any kind of sales tools or mechanism to try getting them to buy it. For once you screen the movie, there’s not much you can do. It’s right there on the screen for you to see. And if it’s awful, ... what if it’s awful? What do you do? You fix it? Maybe, but, there it is.
Here’s the script and here’s the movie. There’s not much you can do, once you screen it. So, the last thing you want try to do... I always come from the conclusion that 80% of the movies will not turn out as expected.

TG: You mean in the production?

Ryan: Yes. And 10%... 80% won’t turn out, 10% will be OK, and 10% are good. Now, those are my odds. Give me different people, they may disagree. But if you go on, a substantial majority of the pictures will not turn out. Or there’ll be problems with them, whatever kinds of problems. You need to try to pre-sell. So, that’s why it’s a pre-sale business.

Ryan, President Worldwide Marketing & Distribution, independent production company

Brad, CEO of an independent production company, confirms Ryan’s views on the timing of acquisition deals and ties it explicitly to the risk factor:

We sell pictures before they are made, we sell pictures while they are being made, and we sell pictures after they are done. Depends on when you can sell it. Obviously I prefer to sell it whenever we can. So we do all three in fact. [...] I prefer to have them in early as long as we get a reasonable price. And that’s because those of us, who operate as independents, are trying to lay off the risk. We are ultimately going to sell the picture and the more sales we can get the quicker the better in terms of getting to our goal to lay off the cost of the movie, trying to build in a profit for the company.

Brad, CEO, independent production company

Since many outright negative pickup contracts will be split rights deals, there may also be conflicts between a producer’s incentive to contract early and obtaining the most attractive deals. Since a movie’s performance in ancillary markets will be dependent on its performance in the primary market (see Section 5.4.1 above), a distribution deal for the domestic theatrical market will normally be the most important. George, an independent producer, explains these potential conflicts in split rights contracting:
George: Nobody is fighting over India. But if you have the UK, France, Italy, or any other heavy territories unavailable, [the studio distributors] will fight for it. [...] If they believe in North America..., you have to be very confident in the movie to take it for North America. That’s where your gamble is huge! Because to release a movie... it’s 20, 25, 30 million dollars. Whereas Japan is nothing compared to that. If they really believe this movie is worth this kind of spending, they want Japan too. Sometimes you have a problem because you sold territories and they want territories, they almost force you to go and buy them back.

TG: Has that actually happened to you, that they...

George: It happened to me with the last movie. And normally you cannot buy it back because you sell it to independent distributors that rarely get a studio-movie, and you go to them and say: “Look, I’ve sold the movie just now to [domestic studio distributor] and they really want Latin America” and the distributor say: “Tough luck. I’m not selling it. We have a contract.” It can be people that we’ve even dealt with them for years and they still don’t wanna sell it back to you.

George, Producer/President, independent production company

While there are incentives for producers to contract prior to production, being able to do so largely depends on the nature of the project and the package at that stage. Projects that have star names committed, that are written by writers with strong track-records, that are handled by high profile reputable producers and that are set to be directed by a successful director – or projects that contain any combination of these elements following its packaging transactions – will be perceived as easier to assess at the packaged stage, while projects containing more unknown and lower profile talent will be perceived to have a higher performance and product uncertainty. For the latter, a distributor would have to rely more on its own assessment of the screenplay and talent qualities, which is less tangible than a star actor’s popularity and a writer, director and producer’s track record. Hence, many would consider the uncertainty too high for making a commitment and wait for the producer to complete production before considering acquisition. Julia, marketing executive at a mini-major distributor, elaborates:
I mean if you’ve got a... a tried and true director, someone who has done it before and he clearly has a vision, producers who’ve done this before, played in this sandbox many times before and gotten it. Maybe it’s a first time writer but you read the script and it’s a terrific script. If you’ve got actors, you know... I mean we’ve worked with both. It depends on what the package is. I think, the scariest thing for a distributor would be to collab with an untested director, untested producer and untested filmmakers in general with the concept on paper and then asking for a financial commitment. And there’s a purpose for that. That’s often when of course a venture capitalist comes in. They are willing to take more of a risk and that’s when people get loans from their families. They finance their first project so it’s actually shot, in the can, and on the screen. And then often it goes around to the distributors and appears at the festivals.

Julia, Executive VP Worldwide Marketing, mini-major distributor

Ryan’s company mainly produces bigger-budget movies at the level referred to by Tom, COO at a major studio, in the introduction to Section 6.2 above. We may call these studio-level movies. These are movies that typically will have star talent committed and are more likely to be written and directed by proven talent. Note that Ryan, who handles these types of movies, says the most common time to do the deals is immediately following the packaging transactions, prior to production. Brad’s company produces movies ranging from the lower tier studio-level budgets to low budget theatrical movies. Also note that the movies acquired following production referred to in Box 6.4 and by Jennifer, executive at a major studio specialty division who typically handles lower budget movies, are sold for much smaller amounts than studio-level movies. In fact, “Happy Texas,” which Jennifer refers to as an example of overpayment and which Variety also refers to as an example of high priced festival acquisitions (Harris, 2005b), was acquired for USD 10.2 million and its production cost has been estimated at only USD 1.7 million (IMDbPro, 2012b). Hence, it seems to be a pattern between the timing of acquisition deals and the project’s budget level being grounded in the nature of a project’s elements and the related product and performance uncertainty. The relationship between budget level or size of transaction on the one hand and contracting on the other will be discussed in more detail in the following chapter, but TCE generally predicts that integration is more likely with higher frequencies or higher transaction volumes.
While an acquisition deal may be done prior to production, this does not directly imply any contribution to production investments on the distributor’s part. Brad, CEO of an independent production company, says:

_The fact that you have made the agreement in advance doesn’t mean [the distributors] pay. They sometimes pay a deposit. We try to get a deposit, but that deposit is refundable if the picture is not delivered by a certain date. The balance is paid on the delivery of the movie or sometimes after the delivery of the movie._

Brad, CEO, independent production company

They distributor’s payment of the acquisition price (except for any deposit or advance) will typically also be subject to the distributor having accepted delivery of all documentation required to establish that the producer in fact controls all the rights granted to the distributor (Farber, 2001c).

**Value Creation**

With outright negative pickup deals, understanding both value creation and value claiming is quite straightforward and uncomplicated at the outset. The producer carries out all production transactions and finances the related investments, which have a high degree of project specificity. The movie is acquired by the distributor, which adds the layers of licensing and marketing transactions, covering the related investments, which also have a high degree of project specificity, before exploiting the movie through various exhibition transactions to the ultimate audience. Value creation is thus shared sequentially, first via the producer’s investments and then via the distributor’s investments until there is a finished movie marketed and licensed to the appropriate retail outlets. This is the cumulative product, or joint product, representing the joint value created from the producer’s and distributor’s efforts and investments.

The sources from which a producer can draw finance to cover its production investments when using outright negative pickup deals vary, but typically the financing is primarily secured via outside procurement through project financing. Few producers operating with acquisition contracting have the internal resources and/or access to debt on the firm’s general credit necessary to cover production investments. Consequently, the financing is typically raised on a project-to-project basis from investors providing equity and debt to the specific project. As project investors, they can only look to
project assets, project-related contracts, and project cash flow for security, repayment and a return on their investments (Finnerty, 1996). As Brad points out above, distributors’ acquisition payments are always made upon delivery of the movie so they cannot be used directly to finance production even when contracted prior to production. Such contracts may however be used as security towards lenders and thus indirectly help to facilitate production financing. An example is provided in Box 6.5 below, and this is usually referred to as pre-sale financing. Loans can in some cases also be drawn against rights for which no acquisition deals are made, which is known as gap financing. Brad explains:

*The bank will often also discount the value of other sales... that is, potential sales. If I’ve sold Germany, but haven’t sold Italy they’ll still lend me some money against Italy based on my track record and the fact that I’ve shown I have enough sales on the picture that it’s likely that I’ll sell the picture out at that level. So it’s a way the bank has to sort of assuring itself that the unsold territories have value.*

Brad, CEO, independent production company

Other common sources include so-called soft funding in the form of tax incentives and subsidies (Kilday, 2009), which are offered by cities, states and foreign countries as incentives to attract film productions. Project-specific equity (i.e. not producer’s equity) is also a common production financing element and, as indicated by Julia above, may be provided by variety of sources ranging from third-party sources, such as specialized film investment funds, venture capitalists and wealthy individuals, to insiders such as producers, directors and actors (as well as their families and friends) (see Box 6.6). Producers may also ask the cast, crew and suppliers to accept a lower payment against the producer’s commitment to make additional contingent payments from the movie’s revenues. The difference between the normal fee and the reduced fee is then referred to as the deferred fee, and such deferrals may be an important source of finance specifically for lower budgeted movies. While these are all common sources, the variety is big and according to Ryan, distribution and marketing executive at an independent production company, “each movie basically has sort of its own financial makeup.”
Distributors will typically draw on internal resources (company equity and debt) to cover the acquisition price and their distribution investments. None of the interviewees were aware of any cases in which distributors have raised project financing to cover distribution investments for a specific movie, and no examples of this were found in the documentation.

**Box 6.5**

Johnny, producer and president of a production company that normally operates under an output deal with a distributor, provides an example in a movie he was not able to make under his output deal but still produced primarily using outright negative pickup deals:

*A movie I’m starting in two weeks is called [title]. We couldn’t get [distributor 1] or [distributor 2] or any of these companies to make the movie. They don’t wanna do it. So we started to go to other companies like [foreign distributor]. So what we ended up doing was: The budget of the movie is about 7.5 million dollars. So we’ve got a little over 5 million dollars from [foreign distributor] for the international rights. We got one and a half million dollars from [domestic home video distributor], for all those rights in the US and we still ended up not having enough money to make the movie. So we found an equity investor for 750,000 dollars. That’s an equity investment against the domestic rights. And they also have a little piece of international rights. So all these pieces, they make up the budget. All the people pay for the movie when you deliver the movie to them. So, you take all these agreements that say they’re gonna pay five and a quarter million on delivery and one and half million on delivery and 750 on delivery. And in your budget you have interest and financing costs. Right. And you take all those agreements and you go to a bank. And you make an interparty agreement amongst everybody. And the bank loans me... we created a stupid company called [title] Productions, for the movie specifically. And the bank funds this thing against the fact that these distribution companies will pay the bank. So it’s for 7.5 million dollars, the bank is gonna loan us 7 million dollars, the rest being their interest... and you go and make your movie. And when you make a movie like that, you tell them up front that the leads, in our case, are [star actor 1] and [star actor 2]. They’re in the movie and that’s all they care about... is that those two people are in the movie. And the rest... – “whatever.”*

Johnny, Producer/President, pact production company
Value Claiming

Value claiming also takes place sequentially. The producer receives its share in the form of the flat acquisition price paid by the distributor. For the producer to obtain a positive return on the production investments the price must exceed the total production investments, as illustrated by Tom’s quote in Section 6.2 above, in which a movie with total production investments of USD 30 million is acquired for USD 35 million. Having paid the acquisition price in an outright negative pickup deal, the distributor retains all film rental and revenues it is able to generate from its exploitation of the movie. For the distributor to reach a positive return on its investments, these revenues must exceed the sum of the acquisition price and its licensing and marketing investments, which is the “what can we really do with it, how much can we really make” question referred to by Jennifer above.

The case of “Happy Texas”, as referred to above, provides an illustration of each party’s risk arising from project-specific investments and the various

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**Box 6.6**

The Los Angeles Times reports on star actor-director Kevin Costner’s investments into the production of movies in which he stars (Horn, 2008):

Costner has one of the longest -- and best -- track records for putting his money where his movie is. Including 1990's Oscar-winning "Dances With Wolves," 2003's "Open Range" and Friday's "Swing Vote," the 53-year-old actor-director has proved remarkably adept at betting on himself, even though Costner says it's not that much of a gamble. […]

Costner decided to star in the film and looked for a backer for "Swing Vote's" tentative $20-million budget. But the model some financiers wanted to use -- by raising capital through foreign pre-sales -- didn't strike him as equitable.

"They want to raise it on your name, but you're not actually benefiting from that," Costner says. "So I looked to my wife and said, 'Why don't we just do this?'. And she said, 'OK.'"

When the film went slightly over budget, Costner kicked in an additional $1.3 million. But then Disney bought the film's domestic distribution rights, and with other territories sold off, Costner says he's now about $1 million in the black.

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forms of uncertainty. Miramax, a distributor, acquired the movie from its producer for USD 10.8 million at the Sundance festival. The estimated production cost was USD 1.7 million, so the producer ended up making a solid return on the production investments. However, this outcome was of course unknown at the time these production investments were made and at which stage there were a significant performance and product, as well as environmental uncertainty, related to the production of the movie. Screening the completed movie at the Sundance festival, the product uncertainty related to the movie in itself was eliminated and the project was also no longer subject to the environmental uncertainty surrounding the production process. Miramax, in addition to other distributors seeing the movie, made a positive assessment of the project, finally putting its value at USD 10.8 million, meaning that the Miramax executives expected to see revenues exceeding this acquisition price plus the distribution investments to be made. However, the movie ended up only generating a domestic box office of USD 1.9 million (IMDbPro, 2012b). While both distribution investments and revenues from ancillary markets are unknown, it is fair to assume that Miramax ended up with a significant loss on its investments, which illustrates the impact of performance uncertainty in relation to how a movie ultimately plays for a commercial audience. So, when outright negative pickup deals are contracted following the completion of a movie, the risk directly related to project-specific production investments and uncertainties surrounding the production process, which we may call the production risk, rest with the producer, while the risk directly related to project-specific distribution investments and the uncertainties surrounding the distribution process, which we may call the distribution risk, rests with the distributor. Note that when outright negative pickup deals are utilized, part of the distribution risk comes from the acquisition of the movie - assessing the value of the movie before it has been released to a commercial audience (performance uncertainty) and then paying an acquisition price (a project-specific distribution investment). In the case of “Happy Texas,” this latter element of the distribution risk caused the producer to end up with a very healthy return on its production investments despite the overall project ending up at a loss, which was taken by the distributor and added to by the high acquisition price. Of course, in other cases distributors may acquire movies for low prices, inflicting losses on producers even if the movies ultimately earn overall profits, thus resulting in the opposite value claiming result.
Contracting

The contracting of outright negative pickup deals is relatively simple compared to other types of production-distribution transactions. The key commitments that need to be contractually safeguarded are the delivery of the movie and the payment of the acquisition price. The primary concern of the distributor is that it obtains all rights and access to all materials necessary to distribute and exploit the movie and that nothing interferes with the distribution, such as claims from the talent or crew participating in the movie or third parties (copyright claims, etc.) (Farber, 2001b). The rights obtained will typically also include the rights to cut trailers and re-edit the movie at the distributor’s own expense. Ryan, marketing and distribution executive at a larger independent production company, elaborates:

I mean if you’re just going to the Toronto Film Festival or Sundance and sit back and screen completed movies, yeah, sure, you can make changes in the movies. You can cut it out, you can shorten it. You can say, “You know, I love your movie but you got to take out that scene and the middle part, it’s too slow and I’m a little confused by the end”. There are a lot of things you can do in the post-production process.

Ryan, President Worldwide Marketing & Distribution, independent production company

The producer’s primary concern is the timing of the payment of the agreed acquisition price and that the conditions that need to be met before payment are made (delivery of materials and documentation) and are clearly defined so that no unexpected holdup in payment can be justified (Farber, 2001c). These are fairly standard contractual safeguards that seldom impose or cause any significant disturbances in the execution of the transaction.

If the contracting is done prior to production it will be somewhat more complex, as the distributor will seek safeguards against any undesirable changes in the nature of the movie from the time the contract is made until the movie is delivered. The contract will therefore typically list so-called approved elements, including the script, budget, director, lead cast and maybe more. If the producer wishes or for any reason needs to make changes to any of these approved elements (e.g. replace a lead actor, see Box 5.4), it will require the distributor’s approval. If changes are made without the
distributor’s approval, the distributor may be able to avoid its obligation to acquire the movie (Cones, 1997), which would have serious ripple effects since the acquisition agreement most likely is used as security for pre-sale financing. Ryan exemplifies:

You’ve gonna have to guarantee that “this movie will be in color, will be shot on 35mm, will be shot in English language, it will... will be no more restrictive than an R rating, or you can say no more than PG13 so therefore it is only one time you can say “fuck.” It’s gonna star Tom Cruise and x y z and Meg Ryan, and it’s gonna be directed by so and so.” And if it doesn’t... if the movie all of the sudden doesn’t have those elements - you don’t take delivery. You don’t have to pay.

Ryan, President Worldwide Marketing & Distribution, independent production company

These additional safeguards reflect the additional performance and product uncertainty affecting the distributor when contracting prior to production, which add a degree of production risk to the acquisition element of the distributor’s investments. The distributor wants to ensure that the completed movie turns out as close as possible to its image based on the package assessment, or that if changes are made the changes are to the distributor’s liking. This requires that a certain degree of decision making control is shifted from the producer to the distributor. From the producer’s perspective this additional safeguard granted to the distributor may be seen as added uncertainty since some control over creative elements is given up throughout the production process. The producer would generally be less flexible when adapting to disturbances (such as replacing a lead actor due to behavioral or environmental uncertainty).

In an all rights outright negative pickup deal, the distributor may ask for the copyright ownership in a movie to be transferred as an additional safeguard, but typically the producer will retain copyright ownership. Thus, the acquisition deal will in legal terms be a licensing agreement and not an acquisition in the form of a transfer of ownership. However, since the term of the licensing agreement will normally be “in perpetuity” (i.e. forever), the contract will still in effect transfer all financial benefits generated by the
exploitation of the movie in the specified media and territories to the distributor forever (Cones, 1997).

In sum, based on the above, one may conclude that even within the sub-case of outright negative pickup contracting there are variations as to placement on the market-hierarchy continuum (Figure 6.2). The pre-sale deals require more safeguards in their governance structure than those contracted following production and should therefore be placed further away from the ideal market form than the latter.

![Figure 6.2 - Positioning of outright negative pickup contracting](image)

**6.2.2 Acquisition Distribution Deals**

The *acquisition distribution* type of contracting is similar to the outright negative pickup deal in that the producer negotiates the terms for the finished movie with one or more distributors, and the distributor putting forward the best offer then gets the product. And again, the contracting may take place prior to or following production, and it may be all rights or split rights deals. However, in the acquisition distribution deal, the producer’s basic financial remuneration is not a flat fee payable upon delivery but a revenue-sharing arrangement between the producer and distributor for the monies generated by the distributor’s exploitation of the movie. The key difference between these two forms of acquisition contracting is thus in the value claiming, but as we shall see this dimension has ripple effects on others, including value creation and uncertainty, and hence also for desired safeguards. For practical purposes the discussion in this sub-section starts with investigating value claiming.

**Value Claiming**

When Tom, COO at a major studio, refers to a *distribution fee* of somewhere between 12.5 and 30% in the introduction of Section 6.2 above, that is a standard type of revenue sharing in which the distributor retains a percentage
of the gross receipts it generates from the exploitation of the movie. The distribution fee rationale is to compensate the distributor for its selling efforts and the maintenance of its home and branch offices, worldwide sales organization and the use of monies for releasing costs (Cones, 1992), or in other words, to cover its nonspecific costs as well as providing a return on its project-specific investments. The percentage of the distribution fee will typically vary between market channels or media. The percentages referred to by Tom above are for the theatrical market. At the outset, as summarized by Tom, the acquisition distribution deal may not seem significantly more complex in terms of value claiming than the outright negative pickup deal. However, what significantly adds to its complexity – and flexibility – is that the value-sharing arrangements, including the definitions of both what constitutes revenues and the mechanisms devised to share these, are contractually defined on a case-to-case basis and not controlled by standard terms defined by law or regulations.

In his critical analysis of acquisition distribution contracting, Cones (1997) points to a number of common contractual terms that may invite opportunistic behavior on the distributor’s part in the value-sharing arrangements. First, the contractual definition of gross receipts determines the pool of revenues that is subject to the revenue sharing, so by applying a narrow definition or alternatively exclude items from the definition, the distributor reduces the amount to be shared with the producer (in most cases without any effect on the distributor’s actual revenues from the movie). Generally, “gross receipts” is defined as all monies actually received from all sources by the distributor (or its subsidiaries or affiliates) from the exploitation of the rights granted pursuant to the distribution agreement (Cones, 1997). However, a number of exclusions are often made and some revenues may also not be collected from the distributor’s licensing transactions. The latter typically occurs when a distributor and theatrical exhibitors or cinema operators agree on so-called settlement transactions (also known as “selling subject to review”, “adjustments” and “look sees”). These are renegotiations of the licensing terms initiated by the exhibitor after an engagement has been completed, when the movie’s performance is known. Such renegotiations are made even if the original licensing agreement includes sliding scale provisions to reduce the exhibitor’s risk from performance uncertainty (i.e. the exhibitor normally retains a larger share of the box office revenues when a movie performs poorly). According
to Cones, distributors routinely settle for a payment that is somewhere between 10 and 30% less than what is owed to the distributor by the exhibitor according to the ex ante licensing agreement. Such settlements obviously also reduce the distributor’s revenues from a given movie, but may still be deemed beneficial by the distributor since it may be made in return for some future benefit. These benefits may include more favorable licensing terms on the distributor’s next movie, to get a future somewhat mediocre movie into specific cinemas that the operator otherwise would have passed on or generally in some other way gain goodwill with the cinema operator. The distributor’s refusal to make an adjustment may result in a premature termination, as discussed in the previous chapter. Settlement transactions are of an informal character and are normally made as oral agreements, and combined with the typical sliding scale complexity of the ex ante licensing agreement (which also allows for certain deductions on the exhibitors side) (Fellman, 2006; Redstone, 2006), this makes it difficult for a producer or its auditor to determine the exact nature of the licensing transaction in question. The typical acquisition distribution contract will include provisions that allow the distributor to make settlement transactions within its sole business judgment (Farber, 2001d).

Among the deductions and exclusions from gross receipts, the royalty-based system used for home video revenue reporting is potentially the most important. Most distributors, and all major studio distributors, have their own home video division acting as DVD/Bluray manufacturers and wholesalers (see Box 5.10). Rather than accounting for and deducting the actual costs associated with each movie to determine its net income, these home video divisions report a percentage of their wholesale receipts as a royalty fee to the parent company, and only this royalty is included in a movie’s gross receipts. The distributor will of course endeavor to set the royalty rate as low as possible, and it has traditionally been set to a default of 20%. The royalty percentage used in the gross receipts definition of any acquisition distribution deal (or any other revenue sharing contracting) will primarily depend on the producer’s (or any other party’s) leverage in the negotiations with the distributor (Blume, 2006).

Another area where distributors may exclude revenues from gross receipts is in the cross-collateralization between individual movies and markets, and in the related issue of allocating revenues between movies bundled for licensing (Cones, 1997). The latter is common for licensing transactions with
television buyers and foreign sub-distributors. Movies are sold in packages that may include a high number of movies for a lump sum, and it becomes difficult to objectively contribute value from the transaction to each individual movie. Consequently, the distributor will typically grant itself significant contractual discretionary judgment, which of course may be used opportunistically to steer revenues away from gross receipt pools (or so-called *pots*) in which larger shares are allocated to producers. This is also referred to as *de facto cross-collateralization*.

Once gross receipts is defined, the question of determining the allocation of the monies, and how they are shared between distributor and producer must be dealt with. From the monies defined as gross receipts in the acquisition distribution agreement, the distribution fee is typically deducted off the top before any other deductions are made. The distribution fee is charged on an ongoing basis, meaning that from the gross receipts reported in any accounting period, a percentage share is deducted and retained by the distributor (see Figure 6.3 below). From the balance, a standard acquisition distribution contract would allow the distributor to further deduct its expenses before any payments are made to the producer (Farber, 2001b). Among these items the distributor’s marketing costs would dominate, as discussed in the previous chapter, but other expenses directly related to a movie would also be deducted and recouped (various taxes, checking- and collection costs, residuals and royalties for unions, etc.). In addition to these direct costs the distributor would normally add further imputed costs such as an advertising fee equal to about 15% of the advertising costs, interest typically calculated at 125% of the prime rate, and in some cases also additional overhead charges (such as a 10-15% distribution overhead), to cover its indirect costs (Blume, 2006; Cones, 1997). Only when these items are covered by a movie’s gross receipt would payments commence to the producer under a standard acquisition distribution agreement. Any payments made to the producer from a movie’s revenues are generally referred to as the producer’s *backend*. A movie’s *net profits* are typically defined as any gross receipts that remain following the deduction of production costs with imputed costs (i.e. following the recoupment of production investments)(Cones, 1992). So generally speaking, in the allocation of gross receipts the distribution fee and the recoupment of the distributor’s direct and imputed costs would have the highest seniority, followed by recoupment of the producer’s direct and imputed costs. However, the producer would
typically retain net profits, basically meaning that once costs are fully recouped, gross receipts less the distribution fee would be claimed by the producer. In this context “net profits” is therefore a contractually defined term that may have a very different meaning from one movie to the next. The distribution fee represents a form of horizontal revenue sharing, while the layered recoupment of distribution and production expenses represents vertical revenue sharing. The recoupment order and declining seniority with which the various items are ordered is often referred to as a movie’s waterfall.

<table>
<thead>
<tr>
<th>Distribution fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution expenses</td>
</tr>
<tr>
<td>$(P&amp;A, \text{imputed costs + interest})$</td>
</tr>
<tr>
<td>Production expenses</td>
</tr>
<tr>
<td>$(\text{negative, imputed costs + interest})$</td>
</tr>
<tr>
<td>Net profits</td>
</tr>
</tbody>
</table>

*Figure 6.3 - A simple waterfall recoupment diagram*

When acquisition distribution contracting is used, it is quite common for the distributor to pay to the producer an advance of the producer’s share of the gross receipts as defined in the particular contract’s value claiming provisions (1992, 1997). Such advances may be paid upon signature of the contract (what Brad refers to as a *deposit* in 6.2.1 above) and/or more commonly upon delivery. If an advance is paid, the distributor will then add it (plus interest) to the items it recoups before further payments are made to the producer. If a movie performs poorly, so that the gross receipts never reach the level necessary for the distributor to recoup the advance, the advance is normally still not subject to repayment by the producer (since at least theoretically, a movie can always generate more future revenues). Hence, these advances are also referred to as *minimum guarantees*. If the
advance or minimum guarantee is high in relation to a movie’s conceived revenue potential, the acquisition distribution deal may in effect resemble an outright negative pickup deal.

The above description and discussion of the value claiming arrangements of a typical distribution acquisition contract are of course not complete, and several of the interviewees indicated that there will be a case-to-case variation from one movie to another. Box 6.7 below provides an illustration of such variations on the standard acquisition distribution contracting described above.

**Box 6.7**

Variety reports from the 2005 Sundance Film Festival (Harris, 2005b):

The voracious 2005 Sundance acquisitions market was noteworthy not just for the number of big-money deals, but for the complexity of the deal-making.

There are more splits rights deals and more backend guarantees. Films no longer sell to the distributor willing to pay the highest advance. It's no longer about being the first person to run through the snow with an open checkbook.

Buyers and sellers are more like studio accountants. They have sophisticated reps, armed with reams of sales data, conversant in contractual arcana like gross corridors and break points.

By the time the fest wrapped on Sunday, more than a dozen films found distribution deals; another dozen were well on their way.[…]

"Financers are less willing to give up the backend as these movies work on a broader level," says UTA agent Jeremy Barber, who was part of the team that repped Craig Brewer's "Hustle & Flow" to Paramount Pictures and MTV Films.

Although the Paramount deal calls for a $9 million advance, the studio's winning play was giving producer John Singleton two put pictures budgeted at $3.5 million each.

"Filmmakers have become far more savvy about holding on to the upside," Barber says.
Some producers are building greater profit participation into their production budgets. Like the founders of InDigEnt, Paul Allen's Vulcan Prods. keeps its budgets down by asking cast and crew to take smaller salaries. Then, when it came time to sell the pic, William Morris Agency and Traction Media negotiated a smaller advance in exchange for significant gross participation.

David Slade's "Hard Candy" went to Lions Gate Films, which agreed to give the filmmakers 20% of the pic's gross. [...]

High-level Sundance dealmaking can be traced back to "The Blair Witch Project." In 1999, the fest's business culture focused almost entirely on the value of the advance. But when Artisan Entertainment and Summit Entertainment jointly acquired "The Blair Witch Project," the companies instituted a series of box-office bumps in an effort to keep down the amount of money they needed to pay up front.

The film finally grossed $249 million worldwide and, after a long dispute during which Artisan seemed unwilling to pay, the Blair Witch team was very rich.

Today, there's nothing accidental about the backend potential of Sundance deals. The total advances on last year's "Saw," "Garden State," "Napoleon Dynamite" and "Open Water" barely top $10 million, but the pics have earned $157 million in domestic release. All are expected to enjoy rich DVD afterlives.

These newfangled deals may take longer to negotiate, but they seem more sensible in the long run. Historically, big advances haven't translated to big business. Buyers and sellers remember all too well the sad case of Miramax Films' "Happy Texas" ($10.2 million advance) or Castle Rock Entertainment's "The Spitfire Grill" ($10 million advance).

Still, sometimes the magic doesn't work. Last year's grand prize winner at Sundance, Shane Carruth's "Primer," was acquired by ThinkFilm for North America shortly after the festival. The deal was weighted toward the back end, but the film grossed just $425,000.

John Pierson, a former producer's rep whose sale credits include "Clerks," "Slacker," She's Gotta Have It" and "Roger & Me," still puts stock in the old approach to Sundance dealmaking.

"Get it up front. That's your bond," Pierson says.

But a new generation of dealmakers has come to the fore in Sundance. And it's no coincidence that Pierson isn't selling any movies this year.
Looking at some of the acquisitions referred to in Box 6.7: In the acquisition made by Lions Gate Films, a mini-major distributor, for the movie “Hard Candy”, the producer obtained 20% of the gross receipts, meaning that 20% payments are made to the producer from all gross receipts in the same manner as the distributor receives its distribution fee. In the industry, such allocations of gross receipts (horizontal revenue sharing) are generally referred to as gross corridors. As indicated in the article, obtaining gross corridors may be particularly important for producers relying on deferrals financing since it allows the producer to start the payments of contingent compensations earlier thus reducing the risk taken by cast, crew and service providers. In the acquisition of the movie “Hustle & Flow” by Paramount, a major studio distributor, the producer received an advance of USD 9 million, but in addition to that the distributor committed to distribute and finance production investments of USD 3.5 million for each of the producer’s next two movies. Such commitments are known as put pictures. Reference is also made to the acquisition of the movie “The Blair Witch Project”, by Artisan, a mini-major distributor, for domestic exploitation and Summit, an international sales company, for international exploitation. Here the advance was kept down by offering the producer a series of so-called box office bumps, more generally known as box office bonuses. These are additional lump sum payments made to the producer when the box office gross reaches certain predetermined levels. Such bonuses simplify the accounting as backend payments are triggered by revenue figures at the ticket sales level, which is relatively easy to verify, rather than by the accounting of the distributor’s gross receipts less a series of deductions.

While not complete, the above discussion of value claiming arrangements in acquisition distribution contracting is sufficient for concluding that, first, these value claiming arrangements are far more complex than in outright negative pickup contracting (but less so when high advances are included), and second, that they therefore also add a layer of behavioral uncertainty based on potentially opportunistic behavior by distributor.

**Value Creation**

Turning to value creation issues, acquisition distribution contracting is at the outset similar to outright negative pickup contracting. The producer and distributor primarily contribute sequentially to a joint value in which the producer carries out all production transactions and finances the related investments, while the distributor handles all distribution transactions and
related investments. However, since the producer’s value claiming is now dependent on the performance of the joint product the distributor’s value creation becomes highly relevant to the producer. This is different than in the outright negative pickup case, in which only the performance of the producer’s own output (how well a movie plays at a market or festival) determines the producer’s value claiming in the form of an acquisition price (pointedly exemplified by the “Happy Texas” case, in which the producer claimed USD 10.8 million from its product despite the producer and distributor’s joint product ending up only generating USD 1.9 million at the box office).

When using acquisition distribution contracting, the producer will be concerned with the distributor’s contribution to the value creation, or generally its treatment of the movie, which will always take place ex post contracting. Hence, the experience and ability of the distributor, as well as its ex ante commitments, become crucial elements to the contracting (Farber, 2001b). First, commenting on commitment, Tom, COO at a major studio distributor, says:

*Tom: They [producers] will say to us we’re not gonna sell it to you unless you at least guarantee 20 million dollars in P&A. We have a movie called “[Title]” that’s coming out from [TV company], which is a sister company. They said to us “you can have the right to distribute, we will pay all the negative costs, all you have to do is to distribute it, but if you exercise your right to distribute you must spend at least 20 to 25 million dollars in P&A.” Perfectly legitimate. And we may say fine or we may not say fine.*

*TG: Right, and these deals are done before the movies are actually produced?*

*Tom: Yes, almost always. I mean it was with “[Title].” I shouldn’t say almost always. Sometimes the filmmakers wait until the film is finished, before they decide how tough they’re gonna be. But in the case of “[Title]” it was an established property, already in television. They knew they had a built-in market, so they said: “We’re going to make a relatively inexpensive animated feature, but we want to know that we have a release date in the summer of next*
year. You can have it, but you got to commit by such and such date to at least such and such amount of money.”

Tom, COO, major studio

So, a minimum amount of distribution investment on the distributor’s behalf, as well as a time frame for the release are two types of commitments sought by producers in this type of contracting. Even though one may argue that it follows implicitly from the investment commitment producers may furthermore look for an explicit commitment to a minimum width of the theatrical release. Julia, marketing executive at a mini-major distributor, says:

*There’s typically a minimum screen commitment and there’s a minimum P&A commitment. So just throwing out numbers: 1500 screens, 15 million dollars. If we then as a distributor decide it would benefit us to spend another million and a half, or 2 million dollars, or 3 million, whatever that figure is – somehow the magic number – then that’s above and beyond contractually what we have obligated ourselves to. But we would make that decision in the hope to generate additional box office, and by generating additional box office then the hope is that we would generate the additional rental and sale on home video and DVD.*

Julia, Executive VP Worldwide Marketing, mini-major distributor

Moreover, beyond these quantifiable commitments, the distributor’s identity matters in acquisition distribution contracting. The producer may seek a distributor with experience in marketing and releasing a particular type of movie, or a distributor with a staff that has certain proven abilities. The importance of experience and ability is evident from the case discussed in Box 6.8.

**Box 6.8**

James, an independent producer, explains how a distributor’s identity and track record of a distributor is important to the producer, making reference to a specific studio distributor’s recent acquisition of a specific big budget movie (referred to as Case Studio and Case Title):
Sometimes there’s just some kind of robust reception to the film, a strong feeling of a common interest. Or, you know, their track record. [Case Studio] just got [Case Title] and one of their selling points was that they went to these guys and they said “[Title 2 – a big budget movie previously distributed by the Case Studio]”. “Look what we did with [Title 2] - 300 million dollars. If you want this movie to perform, how many people had a 300 million dollar movie this year?” Say what you want, they did. And I think that when you’re making a movie that’s this expensive you have to realize that you need to be in somebody’s hands that can go out there and get every single dollar that’s available for this franchise, because there’s just way too much risk. So if somebody’s had a similar kind of movie and has done well with it, or whatever else – those are the things that you also have to think about. They understand this audience, they understand how to speak to this audience. You can make arguments about different kinds of studios and what they do best. And if you really took a step back you really could see a pattern of why certain movies do well at certain studios. It really has to do with their own sort of confidence and their own skill in particular areas or genres.

James, producer/President, independent production company

Emilie, marketing executive at the Case Studio, comments on their acquisition of the Case Title:

Emilie: Well, they went with us because they think that we can … I mean, it is not so much the success that we had this year as much as it was our ability to market big movies. I mean that’s what we are known for – the ability to market “[Title 2]” and “[Title 3, another big budget movie]” and “[Title 4, another big budget movie]” and big movies. People better shopping around, [Art House Title] is not coming here first as much as I’d like them to because my taste runs more to [Art House Title] than it does the [Case Title] with all due respect to the [Case Title] filmmakers. And they [the Case Title producer] met with every studio in town you had to go audition for this movie and they were sold on our abilities and the integrated nature of this company with on the [internet division] and … well, we own [theatrical, home video and international distribution division] and we own the [TV Network] and we own [cable TV division] and we own these magazines [pointing to a stack on her desk]. You know, with our ability to cross-promote a big movie on many divisions without going outside the [parent company] family. So, I think it depends… again, we’re back to what your objective is. Most of the acquisitions are smaller made films. If you had Tom Cruise, chances are that somebody gave you the money before you made it. You didn’t have to round up the money, to make the movie, and shop it around for people to look at it first. They would have said: “You got Tom
As a result of the various value claiming and value creation issues pertinent to acquisition distribution contracting, the identification of the best distribution offer may be difficult, as they are likely to differ in nature, and the producer may have to make a more strategic decision about what aspects to emphasize in the same manner as distributors do when making the offers. Among distributors’ offers for a movie one may have the highest advance, one may have a gross corridor built in, one may have the biggest P&A commitment, and finally, another may not top any of the above but come from the most reputable distributor within the movie’s genre. Sometimes the

\[\text{Box 6.9}\]

Variety reports from the 2007 Toronto Film Festival (Hayes & Jaafar, 2007):

\[\text{Pact for "The Visitor," a movie widely admired since its Friday preem, closed late Monday. [...]}\]

\[\text{Overture [a distributor] prevailed over the handful of other bidders because it "made a large, muscular financial commitment to the marketing of the film," London [the producer] said, "way beyond what's normal for this kind of picture."}\]

\[\text{Overture chief exec Chris McGurk said a fourth-quarter 2007 release was a possibility, but "we're going to speak to the filmmakers after the festival and decide what's best."}\]

As a result of the various value claiming and value creation issues pertinent to acquisition distribution contracting, the identification of the best distribution offer may be difficult, as they are likely to differ in nature, and the producer may have to make a more strategic decision about what aspects to emphasize in the same manner as distributors do when making the offers. Among distributors’ offers for a movie one may have the highest advance, one may have a gross corridor built in, one may have the biggest P&A commitment, and finally, another may not top any of the above but come from the most reputable distributor within the movie’s genre. Sometimes the
quantifiable commitments will be the deciding factor (see Box 6.9), but other times the distributor’s identity will be the determining factor. George, an independent producer, provides an example of the latter:

George: Part of the decision to go to [Studio 1] and not to [Studio 2] or vice versa – in this case with [Studio 2], not with [Studio 1], is listening carefully to what they have to say about what they saw, how did they perceive the movie, how they wanna sell the movie. And only when we feel comfortable, that they got the idea... As an independent producer you make a movie for a reason. And normally it’s not only that you fell in love with the script, you think you can do it differently. Because, you know, it’s all the same stories and [Title] is maybe the best idea of a movie that’s based on [author’s] book, from which a zillion [concept] movies were made. Why did I decide to do this one and then why would [Studio 2] decide to take it and release it on 2,800 screens? Because I saw something in it and I decided to do it, which would be different. Then you need the studio to see it eye-to-eye with you. If they perceived it as just another [concept] movie I probably wouldn’t make a deal with them.

TG: So, it’s about having this common understanding or...

George: The same level of excitement!

[...]

George: You wanna know how much money they’re gonna pay us [the advance], which is the contribution to the negative cost, and how much money they’re going to spend on releasing the movie – that they are willing to commit – and what will be the profit sharing between us. And then... [...] Sometimes you are willing to take lesser amounts of money up front, if you think that the people that you meet and the studio, they are really excited about the movie and they know how to sell it to the public.

George, producer/President, independent production company

From George’s quote, we also see that identity and commitments are closely linked. His ultimate concern is the value he will be able to claim from the movie, and this is dependent on the distributor’s value creation contribution.
This contribution may be signaled in terms of quantifiable commitments to distribution investments, width of the release, and so forth, but alternatively the producer may choose to emphasize trust based on its specific discussions with the distributor staff (“seeing eye-to-eye”), or based on the distributor’s past performance with similar movies. From the producer’s perspective, this reduces the performance uncertainty related to the distributor’s value creation in the same manner as, from the distributor’s perspective when contracting prior to production, experienced talent reduces the performance uncertainty related to the producer’s value creation.

**Contracting**

It follows from the above that both negotiations and drafting will be more complex for acquisition distribution contracting than for outright negative pickup contracting. More elaborate contractual safeguards will be required to govern the distributor’s commitments and rights. A standard acquisition distribution agreement (Farber, 2001b, c) will include provisions on the distributor’s guarantee to release and on its investment commitments. On the guarantee to release, the contract will first state exactly that - that the distributor cannot choose not to release the movie. It may furthermore specify that the release must be theatrical and include cinemas in specified key cities (usually including at least Los Angeles and New York) and foreign territories (if the contract includes international rights). A minimum number of screens for the opening weekend may also be specified, and the producer may also seek limitations in imposing certain release dates upon the distributor to ensure that the movie is released at what is believed to be the most opportune time for the specific movie (for instance, to fit a certain season as for winter-themed movies or to reach cinemas before New Years to hit the so-called award season and qualify for the Academy Awards/Oscars and other awards). The producer will also want to avoid a release date being pushed too far back, as its backend revenues will be accordingly delayed. And maybe most importantly for the producer, the contract will specify the minimum financial commitment from the distributor towards advertising and promotion of the movie – a minimum joint value contribution. It is not unusual that the committed marketing amount is equal to somewhere between 50 and 100% of the movie’s production budget (see Sections 5.4.1 and 7.1.1). However, sometimes the contract may also include limits on these marketing investments in terms of the maximum amount that the distributor may recoup from gross receipts before the producer starts...
receiving a share of the revenues. While relatively rare, this provision occurs when the producer has no gross corridor or box office bonuses so that its revenues in effect equal gross receipts less distributor’s fees and expenses. Normally, the distributor would not have any interest in over-investing into the marketing to the extent that it would hurt the movie’s bottom line, but some, including Cones (1997), argue that distributor sometimes engage in a practice known as buying a gross. The distributor will then excessively advertise a movie during its theatrical release, thereby increasing the box office and gross receipts, and thus also benefit from both increased distribution and advertising fees while being able to recoup its investments prior to the commencement of payments to the producer. If the excessive advertising should create a loss for the distributor from the movie’s theatrical release, the distributor would normally be able to cross-collateralize this loss against revenues from other media and territories, thus still avoiding an overall loss. The producer, being positioned last in the waterfall, will be the party most likely to take a loss from this practice.

Contractual commitments from a distributor beyond a minimum distribution investment and a guarantee to release theatrically are however relatively rare. First, especially when contracting prior to production, there may be too many unknown elements for determining what the best distribution choices for a movie may be. Second, the distributor will normally seek total control over all aspects of distribution, contending that it is in the best position to determine how to maximize revenues, and furthermore that in a competitive and changing marketplace flexibility is required for an optimal release (as for instance with regard to picking the best release date, see Box 5.6). Producers may therefore often seek approval or consultation rights instead, usually having to settle with the latter. Ryan, marketing and distribution executive at a larger independent production company, elaborates:

Ryan: It’s difficult [getting commitments from distributors]. Because when you’re selling... I mean..., let’s go back to “[Title]” with [star actor]. So when we did a deal with... We did a deal with a [major studio] on “[Title].” It was a hybrid. We did have [major studio] agree to release the picture, spending a certain amount of money, the certain minimum they have to spend. It was a certain number of screens they had to commit to release the picture on. We had certain approvals over the date, the dating of the movie, artwork, trailers,... things of that nature. Now, approval is very unusual, you know it’s
very difficult to get approval, because of your studio and they turn to you and say “wait, wait, wait. We just paid an x number of dollars [advance] for this movie. This is what we do; we’ve done for the last 40 years. We’re more than happy to hear your thoughts, more happy to share with you what we’re thinking, but in the event of a dispute or something, we think this is what do for a business. So therefore you really are not gonna tell us, ok, how to do anything. We will be happy to listen to your thoughts, but you’re not going to dictate or have a right of approval.” Unless you’re Steven Spielberg. A lot of it has to do with leverage. Leverage and stature. If you’re Tom Cruise, as a star, you have a lot of approval rights.

TG: So, basically it is difficult for you, as a producer, to get any approval rights in the distribution process.

Ryan: Yeah. You can have consultation, but it’s very difficult for a producer to dictate or tell a studio what to do or how to do it.

Ryan, President Worldwide Marketing & Distribution, independent production company

The specifics of the value claiming arrangement will also have to be negotiated on a movie to movie basis. Farber (2001c) writes: “Undoubtedly one of the most important provisions in the agreement, the division of proceeds and basis for arriving at that division […] is the subject of extensive negotiations” (p. 1774). Acquisition distribution contracts are extensive documents, and the direct transaction costs of negotiating and drafting the definitions of gross receipts and the detailed allocation of these alone from scratch for each movie would in some cases be prohibitively high. Standard contracts and standard definitions are thus utilized. However, “standard” does not refer to any industry-wide standard, but to the contracts that have been developed by each company. Brad, CEO of an independent production company, says:

I use a contract where we control the contract. I use a form that I developed over the years – I’ve been doing this for quite a while – that reflects the AFM [American Film Market] standard ideas, although drafted my way – actually the AFM-contract to some extent was based on my contract. And, of course, when you’re dealing with big companies, sometimes they insist on using their own contracts,
so then you have to react to them - like the studios will almost always use their form agreements rather than our form agreement. But for normal international licensing we use our forms.

Brad, CEO, independent production company

As always, there is a relationship between ex ante and ex post transaction costs. Complex joint value claiming arrangements will add governance costs in terms of accounting and auditing. Shrinking ex ante negotiation and drafting costs may result in less complete contracts, and subsequently, more ex post disagreements and disputes. Too much rigidity in commitments may result in maladaptation. Approval and consultation rights may instigate ex post haggling costs, and so forth. The joint value claiming arrangements for the typical acquisition distribution contract in which the producer finds itself towards the bottom of the waterfall has been subject to many disputes and lawsuits, with the Buchwald v. Paramount case stretching over four years from 1988 to 1992, which was probably the highest profile and most analyzed. Box 6.10 below describes a more recent dispute originating from one of the Sundance acquisition distribution deals listed in Box 6.7. In this particular acquisition distribution contract the distributor also added commitments to the producer’s future movies to sweeten its offer, and it was referred to by Variety as an example of a trend towards more complex acquisition distribution contracting. The contract may however have failed to provide a precise definition of that specific commitment, as the producer later accused the distributor of “asserting self-imposed, non-existent conditions” and finally turned to the court to decide whether the commitment has been fulfilled or not. Apart from the parties’ direct legal costs, they suffer ex post transaction costs from a loss of the relationship and the maladaptation costs of not producing movies.

In sum, complex joint value claiming arrangements that also demand safeguards with regard to joint value creation increase the requirements for transaction governance. Safeguards are added in the form of various contractual commitments and shared decision-making control (approval and consultation rights). This places acquisition distribution contracting towards the hybrid end of acquisition contracting on the market-hierarchy continuum (Figure 6.4).
Figure 6.4 - Positioning of acquisition distribution contracting

<table>
<thead>
<tr>
<th>Market</th>
<th>Acquisition contracting</th>
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<tbody>
<tr>
<td>Acquisition</td>
<td>Distribution</td>
</tr>
<tr>
<td>Pre-sale contracts</td>
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</tbody>
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Box 6.10

Variety reports on a dispute between the parties of a Sundance Film Festival acquisition distribution deal (Abrams, 2011):

It was one of Sundance 2005’s hottest properties. Amy Pascal demanded a print from Los Angeles, and John Singleton’s reps readied memos to make an eight-figure deal. Negotiations carried on late into the night of the screening, and by 5 a.m., Paramount had beaten out Miramax, New Line and Focus to nab its prize: the urban crime drama “Hustle & Flow.”

Six years later, Paramount finds itself the target of a $20 million lawsuit over its hard-fought deal.

In a complaint filed Wednesday in Los Angeles Superior Court, Singleton, who produced “Hustle & Flow,” claims the studio reneged on its promise to “put” two lower-budget projects as part of its distribution pact. “The gist of the ‘puts,’” according to the suit, was that Paramount would finance and distribute the pictures so long as their budgets didn’t exceed $3.5 million each, from which Singleton couldn’t take more than a 7.5% fee per picture.

Par counters that Singleton didn’t hold up his end of the bargain.

“Paramount was hoping that John Singleton would produce two more pictures before his agreement with our studio ended in 2010, but that did not happen,” a
6.3 Output Contracting

Output contracting represents a hybrid transaction mode closer to hierarchy. Generally, these contracts are not made for single movie projects, but to cover all movies made by the producer, its output, within a certain time period or limited by a certain number of movies. Cones (1992) defines the output distribution agreement as “a contract between a feature film production company and a film distributor which provides that, so long as the films produced by the production company meet certain specified minimum requirements, the distributor agrees to distribute all of such films” (p. 350). That an output contract covers a number of movies does not imply that it cannot be analyzed in the perspective of a single movie project. A comparative analysis can still be made between the conditions offered a

Singleton's suit says he turned down offers from other suitors -- at least one of which offered more up-front coin -- but ultimately pacted with Paramount and MTV Films through his Crunk Pictures shingle because the studio offered both a $9 million advance against the backend in addition to the two other films within the next five years.

"Hustle" grossed $23 million worldwide. Court docs explain that 18 months later, Singleton facilitated the studio's acquisition of "Black Snake Moan," penned by "Flow" scribe Craig Brewer.

"Unfortunately, when Crunk attempted to exercise its right to 'put' the two pictures to Paramount, Paramount began asserting self-imposed, non-existential conditions on the 'puts' that prevented Singleton from making the pictures," the suit alleges.

"The only reason Singleton granted Paramount the distribution rights to 'Black Snake Moan' was because Singleton believed that Paramount would honor the puts and Singleton would be in business with Paramount for many years," according to the complaint.
single movie project under acquisition versus output contracting. An implication, however, is that the contract will always be in place prior to production.

Output contracting is a relatively widely defined term encompassing some significant variance to value creation and claiming dimensions, and thus to contracting. It is therefore useful to break the case down into a set of sub-cases commonly found in the industry. In Boxes 6.11 through 6.13 below Tom, COO at a major studio, provides brief descriptions and examples of three types of output contracting, or “producer partnerships” as he also puts it, used by his studio. These correspond to the three sub-cases used here, and are: First-look deals (Box 6.11), co-production financing deals (Box 6.12) and output distribution deals (Box 6.13).

Among output deals, first-look contracting is the most common, but since the annual number of movies produced and distributed under a first-look contract is usually lower than under the two other types, the overall volume of movies is quite evenly distributed between the three types (Bing & Dunkley, 2003).

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**Box 6.11**

Tom provides a brief description of a typical first-look deal:

_Another kind of deal is that we have a producing entity like [individual producer’s] company or producers around the lot. [Individual producer] produced “[big budget movie title],” [another individual producer] who produced “[another big budget movie title].” They are just employees for hire. They say “Are we producing the movie?” “Yes.” “Ok, give me a fee.” “Ok, how much?” “A million dollars.” “All right, you have a million dollars against 5% or 2% or 3% of the gross receipts from this movie.” Why would they get so much money? Because they brought the project to us. [Individual producer’s name] brought “[big budget movie title],” [another producer] brought “[another big budget movie title],” they get a participation because they controlled the property. But they are employees for hire._

---

Tom, COO, major studio
Box 6.12

Tom provides a brief description of a typical co-production deal:

The second kind of producer partnership is that a company comes in like [production company] and they say to me: “Look we are creative partners and business partners, but mainly business partners because we will defer to you creatively,” and creatively the final question is who has the final right to say yes, or no, greenlight, no greenlight, change that screenplay or don’t change that screenplay. And we retain that right. And I have the sole greenlight capacity at [Tom’s studio] and don’t give it to anybody else. So we would say to [production company]: “We’re making the movie and we are going to determine exactly what is changed, what is shot, what the final shooting script looks like, who directs it, who stars in it. But you’re welcome to participate if you wish.” In that case, they come in and they say: “We’ll put up half the money if you’ll put up half the money, but we want an overhead fee tacked on to the budget to help us pay for our [production company] overhead.” We say “ok.” They tack it on, they pay half, we distribute throughout the world except [four territories], where they have very important distribution-ownership relationships, and they say “We need to distribute on those markets.” Then we say “ok.” So we get a distribution edge, because we charge 15%, let’s say, around the world. We say “You know what, we distribute it around the world, we carve off a distribution fee off the top.” So it really is not a 50-50 straight joint venture because we have a distribution edge. We distribute in more of the world than they do. So we have an edge before we have to split money because distribution fees come off the top. Then you might say “Well why would they do this?” Two reasons: One, don’t forget we put that overhead thing on there. Now they pay half of it and we pay half of it because it is part of the budget. But we do make a contribution to their overhead. But secondly and more importantly, they may not have the distribution advantages we have, but they do get into our [North American pay TV service] deal, our [UK pay TV service] deal, they have the power of our domestic video operation, they have the power of our advertising buying rates, they have the power of our print rebate. So they say to themselves “Jee whizz, it costs us 12.5% to let these guys distribute but it’s worth it to us to participate in those deals. We got more than 12.5.” That’s why they do it.

Tom, COO, major studio
Note that the output term is also used in licensing transactions. A distributor may for instance have an output deal with a pay television service under which the distributor is obligated to supply all its theatrically released movies and the pay television service commits to presenting these movies to a set of predefined terms. In Box 6.12 Tom makes reference to licensing deals of this nature that his studio has with pay television services in North America and the UK.

### 6.3.1 First-Look Deals

A first-look deal is a contract between a producer and distributor whereby the distributor provides financing and/or other assistance to the producer in exchange for the distributor having the right of first refusal for projects developed by the producer (Cones, 1992). The development and production transactions are carried out by the producer, but the financing for both is typically provided by the distributor, which also carries out and finances the distribution transactions. Hence, through the financing, the distributor gets more heavily involved at an earlier stage in each project.

Many production companies have one or two key principals functioning as individual producers (project managers) on the movies they produce. For instance, Jerry Bruckheimer is the key principal of Jerry Bruckheimer Films (“Pearl Harbor”, “Black Hawk Down”, “Pirates of the Caribbean” and others) and Ridley and Tony Scott are the key principals at Scott Free (“Gladiator”, “Body of Lies”, “The A-Team” and others). In Box 6.11,
describing producers contracted with first-look deals, Tom refers to these individuals as his studio’s “employees for hire.” This statement reflects just how integrated this hybrid form of transaction is.

Johnny is one of these key principals, and his production company has a first-look deal with a mini-major distributor. Johnny elaborates on his company and the basics of the contract:

It’s myself and five people help me find the scripts, and assistance, and I’ve got a first-look deal with [mini-major studio], which means you can’t work anywhere else unless you show them the material first. And if they pass then you can work anywhere else. [...] They’re paying you, they’re paying your staff, they’re paying for your offices and so on. There’s an expectation that you’re gonna deliver them material that they’re gonna want. Because they’re paying you a lot of money to see that material. So, there’s an expectation, that you’ll be calling them all the time and say “I have something for you to read.” And they essentially want to get that phone-call from you. [...] They’re advancing me certain monies against my producer fees and if I don’t make a couple of movies for them... When you have a deal like that it should in the end of the day cost the distributor nothing. Because they recoup the money that they have advanced to me. They set me up like this, but they’ll get it all back. [...] If you haven’t done any movies and they just paid you all this money, they don’t renew you deal. They’ll say “Buddy, that was the bad decision... So we’re not giving you a deal.” [...] The reason why you do it is because... I wanna pay my development executive 150,000 dollars a year, I wanna pay that guy 50,000 dollars a year and I wanna pay my assistant 50,000 dollars a year and I don’t pay that. [Mini-major studio] does. So, this is my company, but they pay everything. So, they pay my phone bill, they pay my Federal Express. They pay for the water you’re drinking right now. I don’t pay for it. It’s all these costs I don’t have to pay for. So, they help you to create a home to work from. And, you know, it costs maybe a million dollars a year, - that they put up. So you’re gonna have all of this and... I’m not gonna put up a million dollars a year cause I don’t have a million dollars a year. And I don’t get the profits from the movies like they do. So it wouldn’t make sense for me... it would really never make sense for me to personally bankroll all of this.
Cause I would never make financial sense because the only thing I get from my movies is my producer fee. I don’t get these other things. [Mini-major studio] gets all the profit. Whoever is financing the movie gets all the profits, so they can afford to pay for these things I can’t.

Johnny, Producer/President, pact production company

The offices of Johnny’s company are also located within the office complex of the mini-major distributor with which it has the first-look deal. This is a normal arrangement for first-look producers and the reason Tom refers to them as “producers around the [studio]lot” (in Box 6.11) - they are located in office buildings and bungalows on his studio’s premises.

While relatively rare, sometimes producers and distributors also engage in second-look contracting. These are contracts, similar to the first-look deals, between producers that have an output deal with a primary distributor on the one hand and a secondary distributor on the other. Hence, the secondary distributor gets the right of first refusal for all projects developed by the producer that the primary distributor passes on.

First-look deals may be exclusive or non-exclusive. Johnny’s contract, described above, is non-exclusive so if his first-look distributor decides to pass on a project that his company has developed, he is able to take it to other distributors for an acquisition distribution contract and go ahead with production (his company does not have a second-look deal). However, some first-look contracts are exclusive, meaning that if the first-look distributor chooses to pass on a project, the producer cannot take it to any other distributor and the project will not be made. Exclusive first-look deals therefore represent more integrated hybrid transaction structures than the non-exclusive deals. Johnny comments:

I’m like [name of first-look distributor]. But I can work elsewhere. Like for example: The guy whose offices are a couple doors down there, he is a producer and his deal is exclusive, which means he can’t work anywhere else. So, they’re paying him a couple of hundred thousand dollars a year, pay his assistant, he’s based in-house. Basically, he’s here like an in-the-house production company. For I would just go: “Hey, give me an answer, you have five days
and I’m gone, you got five days to answer whether you want to do this or not. Buy the script or else I’m going away.”

Johnny, Producer/President, pact production company

The project described in Box 6.5 was an example of this. Johnny’s first-look distributor passed on it, so instead of doing the movie as an all rights project for the first-look distributor, Johnny took it to a number of other distributors and financed it as a split rights project primarily through pre-sales financing with outright negative pickup deals. Under an exclusive first-look deal, Johnny would not have been able to do this.

Sometimes contracts are designed as hybrids between the typical exclusive and non-exclusive forms. For instance, in a first-look deal between director Martin Scorsese’s production company Sikelia Productions and Paramount, a major studio distributor, Sikelia is able to take projects Paramount passes on elsewhere, but with Paramount then having an option to co-distribute and take a 50% ownership share in any such project (McClintock, 2006a). Other times, the producer-distributor relationship may be formally exclusive, but in effect non-exclusive if the production company principals take on other projects outside the context of their company. This is most common for talent that are also production company principals (Fleming & Garrett, 2007; Goldsmith, 2005; Snyder, 2006).

From the vertical nature of the contracting, first-look deals are normally also all-rights deals in which the distributor controls all exploitation rights throughout the world. However, the distributor may choose to use a first-look project for a horizontal co-production. For instance, “Titanic” was a project that came out of an exclusive first-look deal between Twentieth Century Fox, a major studio, and Lightstorm Entertainment, a production company in which writer/director James Cameron is one of three principals. Before greenlighting the project, Fox chose to structure it as a horizontal co-production with Paramount, another major studio. The distributors both financed production transactions, and Paramount got domestic distribution rights, while Fox retained all international rights (Galloway, 1995; Laski, 2001). Furthermore, the horizontal dimension of a project’s governance structure may change during its execution as parties adapt to changing circumstances. “The Brothers Grimm” (2005, directed by Terry Gilliam) was at the outset structured similarly to “Titanic,” developed and produced by
Mosaic Media, a production company under contract with MGM, a studio distributor. MGM had a horizontal co-production contract with Miramax, another distributor, and the distributors chose to include the project under this co-production contract. MGM further agreed to assign much of its decision making control to Miramax, in effect giving the co-production partner control over the production. Miramax obtained domestic distribution rights to be released under its label Dimension, while MGM intended to take international rights, but retained this in the form of an option as control over the production that was assigned to Miramax. The production turned out to be riddled with problems and disputes between Mosaic (and director Terry Gilliam) on the one hand and Miramax/Dimension principals on the other. Consequently, while the movie was in post-production, MGM decided not exercise its option for international rights (only retaining a minor project-investor position). Miramax was then left with worldwide distribution rights, but lacking a worldwide distribution network, it ended up selling off international distribution rights through distribution acquisition contracting on a territory to territory basis at the film market in Cannes (Rooney & Dunkley, 2004). Hence, due to a distributor’s various horizontal priorities, a project initiated and realized under a first-look deal may also in certain circumstances end up being subject to other forms of contracting towards the end distributor (see also Section 6.4 on layered contracting below).

**Value Creation**

Looking at joint value creation, the production and distribution transactions are carried out by the producer and distributor, respectively, as discussed in Chapter 5, and for acquisition contracting above. However, the essential difference in terms of value creation is that under first-look contracting the investments required for both the production and distribution transactions are covered by the distributor alone. Note that in Johnny’s case the distributor, in addition to all project-specific production investments, is also carrying the producer’s overhead costs, although these are subject to reimbursement from Johnny’s production fees. Sometimes, the monies allowed from distributor to producer are not separated into allowances for overhead and allowances for development. George, an independent producer who previously had a first-look deal with a major studio, refers to them as “housekeeping deals” that pay for overhead and development. So, in these typical first-look cases, the producer does not have to finance any transactions, as all financing is handled by the distributor.
Distributors typically draw on their working capital (internal supply) to cover distribution transaction investments, but for production investments as required for their first-look deals, they may also draw on third-party or off-balance sheet financing (outside procurement). Such outside financing is typically arranged for larger slates or bundles of movies so that one financing transaction may cover a substantial share of the production capital needed for more than one year of operations. The sources may be divided into two categories: First, financial co-producers contracted under co-production financing output contracts (see Section 6.3.2 below) and, second, third-party investors. The line between these two categories may be thin and blurred, but generally entities that are not involved in any production transactions are described as third-party investors, while those also engaging in production transactions (for other movies), thus having production capabilities, are described as financial co-producers. The third-party funding from sources in either of these categories is often restricted in that investors establish a maximum cap of participation in a single movie (e.g. not more than 25% of production costs and not more than USD 30 million per movie) (Goldsmith & Hayes, 2008). Sources are diverse and vary with the climate in financial markets. For instance, international investment banks and hedge funds were particularly important sources prior to the 2008 financial crisis, after which some of these pulled out of motion picture financing, while private and corporate sources in the Middle East and India became more important afterwards (Szalai & Bond, 2009). An example of how a major studio arranges financing from a third-party investor is provided in Box 6.14.
Box 6.14

Variety reports on a third-party financing source arranged for Paramount, a major studio (Gardner, 2006a):

*Paramount has closed a $300 million film financing deal with international investment bank Dresdner Kleinwort for production coin that will fund 30 films for the studio.*

*Deal, dubbed Melrose 2, includes projects from Par's film divisions Paramount Pictures, DreamWorks, MTV Films and Nickelodeon Movies. Not covered in the pact are specialty films from indie labels Paramount Vantage and Paramount Classics.*

*While the deal is said to have just closed, money from Melrose 2 has already been put in play at Paramount to cover production costs on nine pics so far, starting with the March 2006 release "Failure to Launch."


*Melrose 2 is a follow-up financing arrangement to the 2004 Melrose fund that raised $225 million for 25 Paramount pics. That fund was arranged by Merrill Lynch. Dresdner Kleinwort arranged the senior notes on the first fund, paving the way for their lead involvement on the current pact.*

*"We came up with a creative structure and added a few more bells and whistles than the last transaction, which made it very appealing to the studio and the investor community," said Laura Fazio, Dresdner Kleinwort managing director and head of media, global banking. "We have great confidence in [Paramount Chairman] Brad Grey and the slate of films and that was reaffirmed by the investor community with this transaction."

*Current pact is similar in structure to 2004's $225 million fund, sources said, with money being used to fund a "substantial part" of the budget of each of the 30 films in the slate with no exclusions expected.*
**Value Claiming**

Turning to joint value claiming, first-look contracts normally provide for the distributor to claim all revenues generated by the movie since, as Johnny points out above, the basic mechanism most is often that whoever finances the movie (production and distribution transactions) keeps the backend. Exceptions are made, however, and one typical exception is the one Tom refers to in Box 6.11 in which the producer claims a (minor) share of the gross receipts (horizontal revenue sharing), but where the *housekeeping* payments made by distributor to producer are seen as an advance on this share. Hence, the producer will not receive monies from the movie’s gross receipts until the distributor has recouped the full advance (plus interest) from the producer’s share (vertical revenues sharing).

So, generally speaking, producer’s value claiming is in the form of the housekeeping payments. These distributor investments toward the producer’s overhead (which typically will include a fee to the key principal) and development costs will of course vary depending on the leverage of the producer relative to the distributor when the first-look contracts are negotiated. Among the more generous deals reported by Variety is a first-look deal between director/producer J.J. Abrams’ production company and Paramount, a major studio. The five-year deal guaranteed the producer USD 22.5 million: two million per year for overhead, another two million per year “draw” as an advance on J.J. Abrams’ producer and/or director fees, and half a million per year as a discretionary fund. At the other end of the scale there are first-look deals guaranteeing less than half a million per year, and these are often made as a first output contract between distributor and producer off the back of a successful movie for which the parties made an acquisition deal. Since this amount includes overhead support, some of the money provided to the producer is eaten up by costs added by and paid back to the distributor (office rental, etc.) Variety comments that some of these deals “don’t amount to much more than the right to pitch projects to the studio” (Berkshire, Brodesser, Dunkley, Harris, & Timothy, 2002; McNary, 2006).

**Contracting**

One will not find any standard agreement for a first-look contract, or for any other output contract, in the same manner as for acquisition contracts. Compared to acquisition contracts, production-distribution output contracts are relatively rare. They are not done on a per movie basis, but to cover all movies produced by the production company within a certain period. Most
contracts are made for a three- to five-year period, even though they sometimes may be as short as one year and as long as 15 years (McClintock, 2006c). For the most prolific partnerships, one average length first-look agreement may end up covering as many as 20-25 movies. While rarer, first-look contracts are sometimes limited by a certain number of movies rather than by a given time period, but then housekeeping payments are typically adjusted accordingly, and no longer determined on an annual basis. In early 2012, Variety’s output deal overview (including first-look, co-production financing and output distribution types for major studio distributors) showed that there were a total of 155 such deals in force, and the peak registered by Variety was in 2000 when its list included 292 deals (Variety.com, 2012). However, while each contract is customized to its parties, there are some typical elements to their governance structure.

First, the distributor, as the party putting production and distribution investments at risk, will typically have wide-ranging decision making control not only over distribution transactions, but also over the production transactions. Most importantly, the distributor will control production greenlighting, and by controlling greenlighting the distributor will also have de facto approval rights over the screenplay, budget, director, cast and other elements. How this plays out is illustrated in Box 5.2, in which it is the distributor that at the end of a long development process says, “Ok, let’s make a movie.” Michael, former chairman of a major studio and now head of a production company, describes the distributor’s decision making control under first-look contracting:

[The distributor would] be funding all the development of the [production] company, they’d be funding the overhead, all the rest. Then they would say: “We like this picture, we don’t like this picture, develop this. OK, then hire this writer, make these changes, do this, get this director before we say yes. OK, now make the picture, make it within this price.” And you get a fee for producing the picture and some piece of the backend. You’d be an employee.

Michael, Chairman and CEO, pact production company

With authority over production transactions, the distributor will also be more involved in the operational management of the production. Reporting routines are established, with the producer reporting to the distributor, which
is not unlike the reporting of an in-house project manager to its company executives. Furthermore, beyond these reporting routines, the authority of the distributor will be recognized by important personnel such as the director and star cast, and they may thus bypass the producer and directly approach the distributor’s staff with their issues, thereby further involving the distributor in the operational management sometimes beyond what is intended by the contract (see Box 6.15).

**Box 6.15**

James, a producer, discusses the implications of the distributor’s decision making control over production transactions:

> I really think that studios sort of ruin producers, I really do, it’s kind of funny, ’cos I really think... You know they go out and support them, and they make deals with them and so on and so forth, but very few times do studios really support producers, because the producers are considered really to be like this expendable element on the movie. If I’m making a movie with Tom Cruise and I have the reputation I have of being a strong guy, a tough guy, blah blah blah and Tom Cruise and I just don’t get along. And on the fifth day of shooting, who do you think is gonna go home? It ain’t gonna be Tom Cruise! Once they go on camera it's all over with. Now it’s a matter of everybody getting along. Trying to figure out a way to get along, trying to figure out a way to make it work. Even though you have a conflict, part of the skill of the job is understanding and being able to recognize what kind of a creative environment is necessary to accomplish what you’re trying to accomplish. So I really think oftentimes the studios sabotage producers because they’re trying to play like the big shot, like the head of the studio stuff. And you have an argument with the director and the director will say: "Look, we can’t... I need an extra two days for the scene.” And you sit there and you talk to the studio and the studio says: “It’s not gonna happen. We’re not going to spend these two extra days.” And you say: “The reason why the director is suggesting that we need those extra two days is because of the following.” And you lay it all out, right. And you effectively communicate what the problem is, and they come to you and say: “Look, it’s not a matter of not understanding what the problem is, it’s a matter of we’re not gonna spend the money. So what you guys need to figure out to do is how you can communicate what you want to
While distributors have extensive decision making control over production transactions, they have no guarantee that the first-look deals will produce any project deemed worthwhile for the required production and distribution investments. Certain ex ante precautions may be taken. First, a distributor will most often only offer first-look deals to producers with a proven track record, which is seen as more likely to continue coming up with interesting projects. The producer’s experience and track record is often seen as a primary safeguard in first-look deals. Second, certain parameters may be incorporated into a first-look deal (as for instance the production budget range and genre) to steer the development in the direction of projects the distributor wishes to greenlight (Gardner, 2006b). However, producers and distributors cannot escape the performance uncertainty of the development transactions, and producers may not succeed with developing any projects receiving the greenlight from the distributor within the time span of a first-look deal. In this case, the distributor will have no productions from which to recoup its housekeeping payments to the producer, and the deal will have failed to fulfill its purpose of providing movies to fill the distributor’s release capacity. The producer, on the other hand, will retain the monies received from the distributor and may therefore not incur any financial loss, but there will typically be a loss of reputation and relationship. As Johnny indicates above, such unproductive deals will not normally be renewed. Furthermore, even if the copyright ownership to the screenplay should be retained by the producer, the exploitation rights to the screenplay (including the rights to

James, Producer/President, independent production company

communicate in the scene in the number of days that we gave you.” And you say: “Fair enough.” You go back to the director and you say: “You know, I did everything that I knew how to do, but they don’t want to spend the money, and you know, at the end of the day it is their money. And at the end of the day we agreed to do it for this number of days and unless we can figure out a way to pull something from somewhere else, we gotta live with this.” And he says: “Fuck that bullshit, I’m gonna call the head of the studio,” and he picks up the phone, he calls the head of the studio and he says “blah blah blah” and he says exactly the same thing as you said and the studio’s guy says: “You know what, you’re absolutely right, go ahead and take the two days.” You might as well go home because now the guy thinks: You’ve fucked him and you didn’t tell them what was going on, you didn’t do this, you didn’t do that.
create a motion picture based on the screenplay) may be controlled by the
distributor, so the producer would often not be able to take any developed
projects elsewhere upon the expiration of a first-look deal without buying
back copyright and/or exploitation rights (Fleming & Gardner, 2006).

The failure of a first-look deal to create any movies is not limited to deals
involving relatively new and inexperienced producers. Even the most
experienced may have such dry spells. For instance, in 2011 The
Kennedy/Marshall Company, whose principals Kathleen Kennedy and Frank
Marshall have a more than 30-year-long track record of successful movies,
stretching from “E.T.” and the Indiana Jones-movies in the 1980s to the
more recent “The Bourne Trilogy”, “Tin-Tin” and “War Horse,” departed
from a deal at Sony Pictures that did not produce a single greenlight in two
years (Masters, 2011). From the producer’s point of view, this means that
getting a first-look deal does not guarantee getting any movie made and
distributed. Only in very rare cases involving experienced producers will a
distributor commit to greenlighting a specified number of movies under the
term of a first-look deal, which is then referred to as including put pictures
into the deal (Harris, 2002a), possibly to win the producer’s contract in
competition with other distributors.

The safeguards built into a first-look transaction, primarily through the
distributor’s decision-making controls, imply higher governance costs.
Distributors must allocate human resources for supervision and making
decisions, while producers must comply with the reporting system stipulated
by the contract. Sometimes producers experience this as a significant effort.
George, an independent producer who previously worked under first-look
contracting, comments:

>You have much more freedom when you are independent. No, to
work within a studio as a producer is a nightmare, because... Here
is a script [George picks up a script]; [star actor] in a [concept]
and so on and so on. I wanna work on the script. I think [star actor]
is not that good for it so I can just talk to the director, “Let’s find
somebody else.” I don’t mean it, but just as an example. I just can do
it, say to the director “Over and out, let’s get somebody else.” At the
studio you cannot make those decisions. You have to call the studio,
even changing the side character, that’s, let’s say, a man. I want it to
be a woman. He is written as a funny Jew. I wanna make him...
black, Chicano or whatever you want. You have to go to this executive and that executive and so on. It’s just a nightmare.

George, Producer/President, independent production company

For productive first-look contracts, there will be ex ante transaction cost savings compared to acquisition contracting due to scale and scope economies for search, negotiation and drafting costs. Johnny discusses this aspect of his first-look deal:

My deal with [first-look distributor] is that the first film I produce for them, I get x dollars and x backend; the second movie, I get x dollars and x backend, the third movie... It’s all negotiated. So when I sell them something, I don’t have to negotiate with them, I still know what my fee is. It’s pre-negotiated. So I made a deal with them for two years. [...] We had one big discussion that covers years. [...] So, you don’t have to start the relationship every time. [...] Everything is pre-negotiated. So [first-look distributor] asked me if I wanted to make a movie for them a couple months ago. “We want to make this movie, will you do it?” OK. I started it the next day. My lawyer didn’t do anything. It already happened.

Johnny, Producer/President, pact production company

In sum, one may conclude from the above that the hybrid governance structure of first-look contracting should be placed towards the hierarchical end of the market-hierarchy continuum (Figure 6.5). While several interviewees refer to producers working under such contracts as distributor’s “employees,” they clearly are not. The relationship is based on a contract between two companies and is thus defined by contract law. The “employee” reference does rather originate from the extensive decision making control typically granted the distributor within these contracts. Hence, in effect the distributor can to some extent control bilateral adaptation through fiat. Exclusive first-look contracts grant distributors further hierarchical controls, as it prevents producers from obtaining alternative distribution for any product it develops that the distributor does not greenlight.
6.3.2 Co-Production Financing Deals

The co-production financing contracting between producer and distributor is similar to first-look contracting in that it covers a number of movies (an “output”) and contracts typically run for a defined number of years. Also, as with first-look contracting, the distributor will typically not commit to distribute any project the producer brings forward, and the contracts may be exclusive or non-exclusive. Hence, with all these similarities, co-production financing contracts are sometimes referred to in the industry as just “first-look deals.” Yet, a key difference is that under co-production financing contracting, investments for production and distribution transactions are split between producer and distributor. The split may be vertical, in which the producer would typically cover production investments and the distributor the distribution investments, or horizontal, in which the parties split both production and distribution investments. This key difference in the joint value creation between first-look and co-production financing contracts has implications for value claiming and transaction governance. Exactly how investments are split between producer and distributor varies from contract to contract, and this also creates variance in value claiming and governance.

Value Creation

In the example provided by Tom, the studio-distributor COO, in Box 6.12, the basic arrangement is a horizontal split in which producer and distributor each finance half of a project’s required investments, and that the gross receipts are split equally between them. This is quite typical for co-production financing contracts, and so is the distribution fee that the distributor deducts off the top before revenues are split between the parties.
Less typical is the decision making control retained by the distributor, including the right to greenlight, and the final say on creative matters. Tom furthermore says that “We’re making the movie.” That means that in this particular case the producer is primarily a financial co-producer. The distributor therefore uses this co-production financing contract in conjunction with other first-look contracts, so that for each movie the production transactions will primarily be carried out by the first-look producer, while the financial co-producer contributes financing towards both production and distribution transactions via the distributor. The distributor has wide-ranging decision making control over the production transactions through each first-look deal, and it will typically also retain this control in contracts with financial co-producers. Distribution transactions are carried out by the distributor, but the required investments are partially financed by the financial co-producer. Financial co-producers will normally not have any decision making control in distribution transactions, but they may have certain consultation rights. Emilie, a marketing executive at the same studio where Tom is COO, comments on decision making in distribution transactions for the particular case in Box 6.12:

_We have a company that we are partners on a lot of movies called [production company name], which is more of a 50-50 partnership, where they’re with us every step of the way, but I make the majority of the decisions. I talk with them, I go over everything with them. We meet with them all the time but they don’t... In that kind of a deal, even though it’s a 50-50 financial deal... It’s more of a partnership._

Emilie, President Domestic Marketing, major studio

A similar, but more extensive, deal is described in Box 6.16. Here, the financial co-producer commits to co-financing every three out of four movies released by the studio distributor during the four-year term of the co-production financing contract, estimated at approximately 45 movies.
Box 6.16

Variety reports on an extension of a co-production financing contract between Relativity Media, a financing and production company, and Universal, a major studio distributor (Garrett, 2008):

*Under new four-year deal, financier's Relativity Capital subsidiary will funnel billions into studio's slate, providing a steady stream of coin to offset costs. Relativity will co-finance 75% of the studio's slate through 2011 under the arrangement.

This is Relativity's third co-financing deal with Universal and far more comprehensive than its previous two. Relativity's Gun Hill I fund co-financed 17 Sony and Universal films, ending with "The Kingdom," although it was originally intended to cover 18 pics. It was followed by Gun Hill II, also intended to co-finance 18 pics from the same two studios.

This deal is expected to cover 45 pics; each side can nix a certain number of projects from the arrangement. Universal, for example, might opt to retain full control over "The Mummy 3," although that decision has not been finalized. Unlike the previous two funds this one is not built around pre-selected pics.

"It's more or less the entire slate," [Relativity's founder and CEO] Kavanaugh said.

Universal vice chair Rick Finkelstein said the deal's comprehensive nature was a big part of its appeal. "It's much simpler to have this in place," he said. "Now we can focus on the product and less on having to arrange co-financing."

Chief difference in this pact is that Relativity will provide coin from its Relativity Capital subsidiary rather than rely on third-party investors.

"The key focus for us is it's our own money," Kavanaugh said. "We're responsible: It's ours to win, ours to lose."

Deal, unveiled days after Kavanaugh prevailed in the latest round of his legal battle with Michael Sitrick over earlier business dealings, provides U with a steady stream of capital for the bulk of its slate.

"This co-financing model works for us on a number of levels," Finkelstein said. "It helps smooth earnings and it provides us with a lot of cash. Thirdly, it shares risk."
A co-production financing contract in which the producer acts as financial co-producer on some projects, but also covers key production transactions on others, is described in Box 6.17. As indicated by the article’s title, the primary function of this particular contract may be seen as being to co-finance the distributor’s production and distribution investments for 25 movies, but the contract also stipulates that projects developed by the producer shall be among the 25 movies. There is thus a put pictures provision for projects in which the producer carries out at least the development transactions. Also, while primarily a financial co-producer, the company’s executive staff includes experienced production executives, and this investment into human assets that are specific to production type transactions signals an involvement in the production transactions beyond the financing.

Box 6.17

Variety reports on a co-production financing contract made between Warner Bros., a major studio distributor, and Legendary Pictures, a production company that primarily will act as a financial co-producer (McClintock, 2005a):

$500 mil pic fund feeds Warner Bros.

*WB, Tull tally pix for Legendary film slate*

*Warner Bros. Pictures has made a deal with venture capitalist Thomas Tull's Legendary Pictures, which will invest $500 million in a slate of films they will jointly produce.*

*Tull told Daily Variety that Legendary and Warners would be 50-50 co-financing*
partners on 25 films to be produced over the course of the multiyear pact. The slate will include films developed by Legendary, which is backed by a cadre of private equity funds.

Legendary's president is former TriStar production head Chris Lee, who is producing "Superman Returns" for Warners.

Larry Clark, former chief financial officer of Creative Artists Agency, is Legendary's chief operating officer and CFO, while marketing vet Scott Mednick is chief marketing officer. William Fay, previously president of Centropolis Entertainment, is Legendary president of physical production.

Warners and Legendary intend to team up on major event releases and varied genre films, which the studio will distribute. […]

"From the very beginning, we built this plan specifically around private equity and returns," Tull told Daily Variety. "I myself would not have done this deal six or seven years ago. But the advent of DVD and overseas expansion of the box office has made the movie business much more attractive as an asset class."

Tull, who serves as Legendary's chair and CEO, will move to Los Angeles from Atlanta. He was most recently director of media and entertainment holding company the Convex Group.

Tull incorporated Legendary nearly a year ago, but kept the company's formation under wraps.

"As the process of mounting, marketing and distributing motion pictures remains highly competitive and costly, we welcome the partnership of a skilled, knowledgeable team who can help us manage our risk as we continue to develop and produce top-quality filmed entertainment for the global marketplace," Warners president and chief operating officer Horn said in a statement.

Legendary's investors include ABRY Partners, AIG Direct Investments, Bank of America Capital Investors, Columbia Capital, Falcon Investment Advisors and M/C Venture Partners. San Francisco-based investment banking firm Perseus acted as financial adviser to Legendary Pictures in the transaction.

Legendary is expected to be based on the Warners' lot, where some execs noted that the cash infusion from private equity was a "vote of confidence" for the movie biz.

Variety later reports further details on the contract (McClintock, 2005b):
From Boxes 6.16 and 6.17, one sees that the financial co-producers’ sources of financing are similar to those of the studio distributors’ third-party investors described in the previous section (and in Box 6.14).

As briefly discussed under value creation in Section 6.3.1 above, financial co-producers are generally defined as such and not as third-party investors because they engage in production transactions. These may be within the context of the co-production financing contract, as is the case for Legendary Pictures (Box 6.17), or it may be outside, as is the case for Relativity Media (Box 6.16). Relativity, which is one of the industry’s biggest financial co-producers, having co-production financing deals with two major studios, Sony and Universal, also has a so-called “single-picture business” in which it finances and produces movies that are contracted to distributors under acquisition contracting on a movie-to-movie basis. Under its co-production
financing contracts, Relativity is not involved in the production transactions, but for the single-picture business it is also creatively involved, and these transactions are supported by a specialized and experienced production team within the company, i.e. assets specific to production transactions (Siegel, 2008a, b).

Finally, there are co-production financing contracts in which the producer is carrying out all types of production transactions in addition providing finance for the required investments. These are the most interesting co-production financing contracts in terms of representing a sub-case in this study since the producer here operates as the sole producer and not in conjunction any other producer on a specific project. In these contracts, the financial split will typically be vertical. An example is provided in Box 6.18, described by Michael, who is chairman and CEO of a production company that has this type of co-production financing contract with a major studio distributor.

**Box 6.18**

Michael, head of a production company, talks about the financing and production of their movies under the co-production financing contract with a major studio distributor:

*Michael: We finance all our company. We finance all our development, all of our overhead, all of our infrastructure. Everything. All of our productions. [The output distributor] just gives us an advance on each picture that they accept. […]*

*TG: At the time you take a project to [the distributor] and they accept it, they give you an advance that you use as a part of the production financing, is that correct?*

*Michael: It would be used as a part of production financing, yes. […]*

*TG: Where do you get the production financing from? What are your sources?*

*Michael: We have equity in our company, which is a piece. We have the domestic advance and each of the partners internationally provide us with an advance based upon the percentage of the budget that their territory is*
In Michael’s contract there are no housekeeping payments, as in the first-look deals. All investments required for development transactions are carried by the producer. Investments for the production transactions are carried by both the producer and distributor. The distributor’s contribution is made in the form of an advance which the distributor recoups from its gross receipts before any of its revenues flow to the producer, not unlike the use of advances described for the acquisition contracting above except in Michael’s case advances are paid prior to production and not upon delivery. The producer’s contribution to the production investments has two main sources: Some is drawn from the company’s equity (internal supply) and some comes from international partners (outside procurement). These international partners that Michael refers to are distributors in several foreign territories with which the production company also has output contracts. Michael’s company uses these advances for partial production financing in a similar way as distributors’ advances are used for pre-sale financing under acquisition contracting (see Box 6.5), with the exception that these distributors are already contracted and committed. Michael thus benefits from search, negotiation and drafting scale economies in these foreign output...
deals in a similar fashion as described by Johnny for first-look deals above. So, to obtain the financing for its part of the production investments Michael’s company is therefore dependent on making the co-production financing contract with the domestic distributor a split rights type of contract. Without retaining exploitation rights to foreign territories in which it can make separate output deals with local distributors, Michael’s company would not have been able to raise its share of the production financing in the way it does. However, not all co-production financing contracts for producers carrying out production transactions are as dependent on split rights as Michael’s. In a very similar contract between Pandemonium, a production company, and Disney, a major studio distributor, the distributor takes all exploitation rights, excluding only the Spanish and Japanese territories, as well as Italian and domestic free-TV rights, to be retained by the producer. Pandemonium must therefore draw on different sources of finance to cover its production investments, to which Disney only contributes a minor share. Consequently, Pandemonium raised USD 370 million in debt and equity financing with the aim to co-finance 15 to 20 movies over the contract’s five-year term. Since the senior debt component of the funds would be replenished over the course of its term as a revolving securitization, the funding allowed Pandemonium to contribute a total of about USD 1 billion in production financing under the contract (Brodesser & Diorio, 2003; Harris & Dunkley, 2001). A similar example is provided in Box 6.19. Here, Dreamworks, a producer, carries out and finances all production transactions, and the distributor, Disney, carries out and finances all distribution transactions. However, Disney is also providing debt financing, which together with other debt financing from a bank syndicate and equity from a corporate investor provide the financing necessary for Dreamworks to cover its production transactions.

Unlike in the example provided by Tom in Box 6.12, Michael’s production company does not provide any financing for the distribution transactions (and neither does Pandemonium nor Dreamworks). These are carried by the distributor alone, and the distributor recoups these off the top (following the deduction of its distribution fee and prior to recoupment of its advance). Accordingly, the distributor retains decision making control for these transactions, but only while working closely with the producer. Michael comments on the producer’s involvement and distributor’s control:
We are very much involved: Coordinating the release date and the marketing planes [between territories]. They [the distributor] have a high degree of participation and involvement and some areas of control over that segment of the... [...] They would control the final decision on the release date of the film, for example. Or final control of how many screens they would arrange initially, domestic, and so forth.

Michael, Chairman and CEO, pact production company

Box 6.19

Variety reports on a co-production financing contract between Dreamworks, a producer, and Disney, a studio distributor (Siegel & Graser, 2009):

Disney has officially added DreamWorks to its Magic Kingdom.

The Mouse House inked an exclusive long-term distribution pact with DreamWorks over the weekend. Accord will add six more pics to Disney's release schedule beginning in 2010 and pairs Steven Spielberg with the family-friendly studio. Overall, Disney will distribute 30 DreamWorks pics through the Touchstone banner over the next five years.

Studio's annual output will now grow to 20 pics per year -- a dramatic departure from its cost-cutting strategy, instituted in 2006 to reduce its overall annual slate to some 12-15 films.

Under terms of the new deal, Disney will handle distribution and marketing for DreamWorks' titles through its Touchstone banner, collecting 10% of the gross of each pic.

It will also retain homevid and TV rights for the films, outside of India [home territory of Dreamworks equity investor Reliance Big Entertainment], and cover overhead costs for DreamWorks, which will remain based on the Universal lot. [...] Under the deal, Disney will provide a much-needed bridge financing loan to DreamWorks, which has had trouble raising money to match a commitment from Mumbai-based Reliance amid the worsening global credit crunch.

DreamWorks said it is halfway to raising the $325 million it needs to take
advantage of an additional $325 million from Reliance -- both figures have already been downsized from original goals of $700 million in loans and $500 million from Reliance.

The Disney loan (the amount was undisclosed) will help DreamWorks reach that goal and enable it to continue operating as a major production shingle at a time when belt tightening is eliminating thousands of jobs in Hollywood.

For Disney, outside of the influx of creative talent, more pics on its sked means a greater opportunity to utilize the impressive distribution and marketing machine it set up worldwide but hasn’t been able to exploit given its smaller slate.

"The DreamWorks deal gives Disney the opportunity to leverage its global infrastructure without incurring further financial risk," said Walt Disney Co. topper Bob Iger, who has had a long relationship with DreamWorks execs after pairing with them to launch DreamWorks TV in 1994 while at ABC.

A separate report confirms that Disney would cover all distribution investments (P&A) under the contract (Siegel, 2009).

The Hollywood Reporter provides further detail on Dreamworks’ financing (Diorio, 2009):

[...]DreamWorks on Monday announced that it has concluded the arduous process of rounding up a total $825 million in corporate financing for the reborn film company. That sum includes a $325 million JP Morgan-led bank syndication, a matching amount from DreamWorks principal Reliance Big Entertainment and a $175 million commitment from distribution partner Disney. [...] 

In a recent interview, Snider succinctly summed up the business and creative aims of the reincarnated studio. "Commercial, quality entertainment is the mantra," she said.

In other words, don’t expect any art films or limited releases, as DreamWorks begins to pump movies through Disney's distribution pipeline. Its agreement with the Burbank studio also provides for TV and home entertainment distribution of its film titles.
Value Claiming

Joint value claiming under co-production financing contracting most closely resembles that of a split rights acquisition distribution contract for a single project (see Section 6.2.2). From its gross receipts the domestic distributor will typically deduct a distribution fee (usually in the 12-15% range) off the top. If the distribution investments are split between producer and distributor (horizontal splits, see Boxes 6.12 and 6.16), revenues are normally also split directly following the distribution fee deduction. If the distributor covers distribution investments alone (vertical splits, see Boxes 6.17, 6.19 and Michael’s case), it will then typically deduct an amount equal to its distribution investments, which may also include interest and other imputed costs (see Figure 6.6 below). If the distributor also has paid an advance to the producer (as in Michael’s case) this advance, plus possibly further imputed costs, will typically also be deducted before cash flows to the producer. How far upstream in the waterfall the producer is positioned will greatly depend on the bargaining power between the parties to each individual contract, but generally those which co-finance distribution investments in addition to production investments will be placed further up, while those which only co-finance production investments will find themselves further down. A horizontally split finance will typically be reflected in a horizontally split waterfall, while a vertically split finance will result in a vertically split waterfall but follow the industry’s usual “last in, first out” principle.

In addition to its share of the gross receipts, the producer may also receive an overhead or production fee which is paid out of each project’s production budget. For producers carrying out production transactions, such fees are always included, but they may also be included for financial co-producers (as seen in Box 6.12).

In some rare cases, the distributor may also make housekeeping payments towards the producer’s overhead (Box 6.19).
Figure 6.6 - Simple waterfall diagrams for vertically and horizontally split contracts

For some split rights co-production financing deals, like for Michael’s company, the producer’s possibly most important source of value claiming is the foreign territories that are not directly tied up in the production financing through output deals. These are territories the producer, or its sales agent, can sell to local distributors through acquisition contracting (outright negative pickup or acquisition distribution deals), and these revenue streams then belong exclusively to the producer. Control and ownership of the exploitation rights for these territories will typically represent an important part of the producer’s safeguard for its equity (internal) financing.

**Contracting**

With each party putting up part of the project financing, both will seek safeguards to protect their highly project-specific investments and the nature and combination of these safeguards will vary from contract to contract, following the variations in the contributions to the joint value creation. Looking first at decision making control, and starting with the production transactions, control may rest with the distributor as in the case at Tom and Emilie’ studio presented in Box 6.12. Here, the investments are
split horizontally 50/50 between the parties, and the producer is a financial co-producer not carrying out the transactions. However, financial co-producers will typically have consultation rights and stay involved with the production throughout (see Boxes 6.16-17). Hence, the financial co-producer may safeguard its investments by investing in personnel with production expertise, i.e. human capital specific to the production transactions. In Michael’s case (Box 6.18), and this is typical for vertically split deals, it is the producer that has decision making control over the production transactions, even though the distributor contributes to the investments. However, the sharing of investments only starts following the greenlighting of a movie. The development transactions, for which product uncertainty is the highest, are financed by the producer alone. In Michael’s case, it is also the production company that carries out the production transactions. Furthermore, in co-production financing contracts that involve advances from the distributor used towards production investments, the distributor may seek provisions for cross-collateralization between projects. Hence, if one movie should underperform in the market to the degree that the distributor is not able to recover its advance, its loss may be recovered from better performing projects under the same contract.

While Michael’s co-production financing agreement primarily provides for the producer to finance production transactions (less the distributor’s advance), the producer has an option to also participate in some projects in which the distributor finance production. Michael stresses the difference in decision making control between these and their standard co-financing projects:

*We have a couple of projects involved with more... traditional studio finance aspects. But in that case you’re a form of an employee. Independent boy, but you’re a boy.*

Michael, Chairman and CEO, pact production company

The greenlight decision will often be shared between producer and distributor in some form. In Michael’s case it is his company that makes the decision, but the distributor has the option not to participate (and thus also not provide any advance). These projects the producer may then take to any other domestic distributor. This resembles non-exclusive first-look contracting. In Tom’s case with the financial co-producer (Box 6.12), it is
the distributor that greenlights projects, and often in such horizontally split cases it is the producer that has the option not to participate. In the extensive co-production financing contract between financial co-producer Relativity and studio distributor Universal (Box 6.16), the contract intended to cover most of the distributor’s movies, but as an exception each party is given the option to exclude a certain number of movies. Usually, in less extensive contracts, a financial co-producer and the distributor will negotiate ex ante which of the distributor’s movies the producer shall participate in, as in Relativity and Universal’s prior contracts. The distributor may for instance offer participation in a selection of upcoming movies, and from this selection the producer will choose which it wishes to co-finance (Laporte & Snyder, 2006). According to Emilie, marketing executive at the same studio as Tom, distributors will often not offer but try to exclude projects for which they are highly confident about a positive result, such as popular franchises and sequels. In some rare cases the producer may control the greenlight even when the distributor is covering a significant share of the production investments without leaving any option for the distributor not to participate. A co-production financing agreement between Revolution Studios, a producer, and Sony, a studio distributor, included this allocation of greenlight control (Laporte, 2006b). This contract, however, was a result of competitive negotiations between Revolution and several distributors at a time when the apparent talents of Joe Roth, Revolution’s founder, for picking and producing successful movies were in great demand. He had just stepped down from a successful run as head of Disney, a major studio (Lyons & Goldsmith, 2000). Furthermore, the contract was extensive in that it also included as a commitment on the producer’s behalf to produce a minimum of 39 movies during its six-year term, thus supplying a significant share of the distributor’s release slate. The competitive environment in which the contract was negotiated, and its extensive reach, may help explain the unusual delegation of greenlight control.

Under co-production financing contracts, it is not uncommon for the distributor to commit to a certain number of put pictures, which ensures the producer that a minimum number of the movies it (co-)finances will be marketed and released by the distributor. In some rarer cases the distributor commits to releasing all movies (see Box 6.19), but this is more typical for output distribution contracts. When no put pictures are contracted, the deals will typically be non-exclusive, since it would be unacceptable for a
producer financing its own development transactions and with funds for production transactions risking that the distributor in effect prevents any movies from being made by rejecting all for distribution or greenlight, as distributors would be able to do under exclusive first-look contracts.

Copyright ownership will normally be taken by the producer under vertically split co-production financing contracts. It is the producer that finances the initiation of the projects and the origin of the copyrighted properties through its development transactions, and the distributor’s contribution to the production financing, if any, is typically defined as an advance. In horizontally split contracts in which the producer is a financial co-producer, ownership will typically be shared between producer and distributor.

Some more closely integrated alliances between producers and distributors are created by combining a co-production financing contract with shared equity. Typically, the distributor will take a minority equity stake in the production company against an investment in an existing company or co-founding a new production company with individual producers. An example of the first is a co-production financing alliance between Fox, a major studio, and, New Regency, a producer, made in 1997. Here, a co-production financing contract with a 15-year term was joined with the distributor investing USD 200 million against a 20% ownership share in the well-established production company. In line with the equity partnership and the contract’s long term there was also significant flexibility built in with regard to the producer’s option to co-finance or fully finance its movies (Petrikin, 1997). Hence, it could be used as both a co-production financing and an output distribution contract. The Sony-Revolution alliance discussed above had a similar equity structure between distributor and producer. An example of the distributor participating in setting up a new production company is found in the alliance between Illumination, a producer, and Universal, a major studio. In 2008, the distributor offered Chris Meledandri, who was then President at Fox Animation, the animation division of a major studio, to set up a new co-owned production company to provide the distributor with family-friendly movies under a co-production financing contract. The distributor furthermore took the lead in identifying and bringing in third-party investors for the new company so that it could contribute to the financing of its movies (Fleming, 2008b). In some rarer cases, the producer may also take an equity stake in the distributor, but these are then independent or mini-major distributors (Zeitchik, 2009b).
In sum, co-production financing contracting represents a lesser integrated form of output contracting than first-look contracting. As the parties share highly project-specific investments, this is reflected in more shared control in the contracting. Again, exclusive contracts represent a higher degree of integration than non-exclusive contracts. Furthermore, contracts supported by shared equity are also more integrated, as they give one party ownership control and/or supervision of the other (Figure 6.7).

![Figure 6.7 - Positioning of co-production financing contracting](image)

**6.3.3 Output Distribution Deals**

Output distribution contracting is similar to the other forms of output contracting discussed in the two previous sections in that it covers a number of movies (an “output”), contracts typically run for a defined number of years and the contracts may be exclusive or non-exclusive. The key difference is again in joint value creation: Under an output distribution contract, the producer will be responsible for all investments, including those required for a project’s production and distribution transactions. An example is provided by Tom, COO at a major studio, in Box 6.13 above.

While there are variations among output distribution deals, they vary less than co-production financing deals. Differences between deals are primarily found in how marketing transactions and distribution investments are organized.

**Value Creation**

In the example provided by Tom, COO at a major studio distributor, in Box 6.13, the basic arrangement is that the producer is responsible for all
investments required for production and distribution transactions. This is typical for output distribution contracts; it is primarily what defines them as a separate category of output contracts. However, while the producer is responsible for distribution investments, it may be the distributor who provides the cash flow on the producer’s behalf. Tom explains:

*When [head of the production company] comes in [with a movie], he has already paid for the cost of making the movie, he has paid for the negative, now he is responsible for P&A [distribution investments] also. But we advance it. So we say, “You know what, his move cost 35 million dollars, we’re advancing 25 in P&A.” What are the odds that we will not recoup 25 million from all of domestic theatrical, home video, pay-television, airlines, DVD? We feel very comfortable. We have never failed – on “[title of underperforming movie]” we made 9 million dollars.*

Tom, COO, major studio

In other words, since distribution investments are recouped prior to production investments in a movie’s waterfall, the distributor generally assesses the risk associated with the investments required for its own distribution transactions to be low enough for providing a cash flow loan to the producer covering its own out-of-pocket distribution costs for a movie. Imputed distribution costs do of course not need to be cash flowed, so the amount cash flowed may be lower than the amount recouped. And again, since these are multi-picture contracts, the distributor may also include cross-collateralization provisions, thereby allowing it to recoup any unrecovered advances from other more successful movies. So while the producer is responsible for the distribution investments under output distribution contracts, the distributor will typically advance the monies required (Harris, 2002b), thus representing one source of financing for the producer.

Under distribution output contracting it is not common for the producer to raise project financing, but rather to raise corporate finance sufficient to cover the investments anticipated under the contract. One may say that the production company becomes the project company (for this slate of movies). In this context, the producer’s other sources of financing (used in addition to distributor advances) vary and are usually a mix of equity (internal supply)
and debt (outside procurement), which is similar to that discussed for co-production financing contracting above. Some producers are primarily debt financed, as in the Box 6.20 example in which the projects and thus the lenders’ collateral are based on intellectual properties (comic book characters) that are well established in the market, which may signal less uncertainty. Others are primarily equity financed, as in the Box 6.21 example in which the projects are primarily original and the production company is also relatively new, which may signal a higher degree of uncertainty. For these two extreme examples, financing governance structures therefore seem to follow TCE predictions (Williamson, 1988).

Production transactions are all carried out by the producer, while distribution transactions are split between the producer and distributor or carried out by the distributor alone. Hence, in the industry, output distribution contracts are sometimes referred to as rent-a-distributor and rent-a-studio deals. In the example provided by Tom in Box 6.13, the distributor carries out these transactions under the supervision of the producer. The producer “rents” the services and expertise (assets specific to distribution transactions) from the distributor, rather than integrating similar assets into the production company. However, to supervise the distribution transactions the producer also needs experienced distribution staff, so producers operating under output distribution deals will typically have its own marketing and distribution executives supervising and collaborating with the distributor’s marketing and licensing divisions. Alternatively, the producer may use outside procurement by hiring such services from specialized movie marketing consultancy firms, which are typically run by former studio marketing executives (Graser, 2008). Emilie, marketing executive at the same studio where Tom is COO, comments on the collaboration with producers under output distribution contracts, using the same example as Tom in Box 6.13:

*And certain relationships that we have are straight distribution deals. For example a company called [producer]. We are their distributor and their marketer. They fund their own movies, both the negative cost and the P&A cost. So we execute their marketing campaign and conceive their marketing campaigns. It’s not my decision at the end of the day. I say, “You should spend x amount of dollars to open this movie. And you should target this audience and*
you should do this and this”. And they think that they only wanna spend this much. It’s their money. They make the decision.

Emilie, President Domestic Marketing, major studio

Under some output distribution contracts the producer also carries out the marketing transaction, leaving only the licensing transactions to the distributor (Hayes, 2007; Mohr & McClintock, 2006). This requires the producer to make further overhead investments in assets specific to marketing transactions unless it chooses to outsource the job to a consultancy rather than to the distributor, which may be difficult as consultancies primarily are set up to work with the distributor’s marketing departments rather than as a replacement. However, if integrated into the production company, it gives the producer full control over all transactions from development through marketing. Under these contracts, the distributor would normally not advance marketing investments.

---

**Box 6.20**

Los Angeles Times reports on a non-exclusive output distribution deal between Paramount Pictures, a major studio distributor, and Marvel Studios, a producer (Eller, 2008a):

*After the success of this summer's blockbuster "Iron Man," Paramount Pictures and Marvel Studios have extended their distribution deal for five more movies.*

*Under the agreement, Paramount will take a smaller distribution fee from Marvel -- 8% rather than the 10% it had received for releasing "Iron Man" -- in exchange for gaining worldwide distribution rights to the pictures. Paramount, which released the action movie in the U.S., Canada and some overseas territories, will also now distribute Marvel's films in such key markets as Japan, Germany, France, Spain, Australia and New Zealand.*

*Previously, Marvel had licensed distribution rights to local distributors in those territories. Paramount will distribute "Iron Man 2," due out May 7, 2010, worldwide with the exception of Germany, where the sequel was already committed to a local distributor.*

*The other films included in the newly extended Paramount pact are "Thor" in 2010, "Captain America" in 2011, "The Avengers," also in 2011, and "Iron Man*
3," which does not yet have a release date.

Paramount Pictures Vice Chairman Rob Moore said the company agreed to take a lower distribution fee because it would get more films to distribute in a greater number of territories, which could be more lucrative for the studio.

David Maisel, chairman of Marvel Studios, a unit of publicly traded Marvel Entertainment Inc., said that given the success of "Iron Man," it made sense to continue the distribution pact with Paramount on "improved economic terms." By releasing through one worldwide distribution partner, Maisel said, Marvel believed that it could "maximize the upside" of its movies.

In a regulatory filing Monday, Marvel said it had received its first "Iron Man" check from Paramount in the amount of $60 million.

The company forecast revenue in its film production division of $125 million to $140 million this year, up from its earlier projection of $65 million to $80 million.

Marvel, which used to rely on studios to bankroll its movies, has been self-financing its pictures since securing a $525-million loan arranged by Merrill Lynch & Co. in 2005. In its filing, Marvel said it would fund 33% of the budget of each film covered by the new distribution deal and its film facility would provide the remaining 67%.

Maisel, who declined to divulge the cost of any individual movie, has told Wall Street analysts that the company's budgets range from $135 million to $165 million.

In an earlier report Marvel’s CEO Ari Arad commented on the company’s debt financing (Gross, 2006):

[...] Just after Labor Day, Marvel rolled out a $525-million debt facility to finance the production of up to 10 big-budget ($165 million a pop) live-action films based on comics characters. "It's taken time for the financial markets to recognize the incredible value of these properties," Arad says. Wall Street will help transform Marvel from licensor to producer in a deal that will give it complete creative control and allow the company to build a film library. [...] As great as it is for Marvel to finance its own movies -- quite a turnaround from its bankruptcy filing less than a decade ago -- unlike other deals if it ends up defaulting on the debt, a bunch of banks could end up with a group of superheroes. "If we screw up, the investors own the IP," Arad says.
**Box 6.21**

Variety reports on a non-exclusive output distribution contract between Media Rights Capital, a producer, and Universal, a major studio distributor (Garrett, 2010):

*Media Rights Capital's new deal with Universal represents the biggest rent-a-studio pact with a major since Disney joined hands with DreamWorks.*

Agreement calls for Universal to distribute 20 MRC pics over five years beginning in 2011. The deal ratchets up the relationship between MRC and U, who first joined forces on "Bruno," and are next set to collaborate on "The Adjustment Bureau," set for release Sept. 17.

Previously, MRC has secured distribution on pic-by-pic basis. Warners, for example, distributed Robert Rodriguez's "Shorts," and Sony will handle "30 Minutes or Less," the upcoming comedy from "Zombieland" helmer Ruben Fleischer.

The arrangement gives MRC access to studio distribution at a time when it has become more precious -- and this could help MRC entice stars to its productions. The deal does not preclude MRC from preselling pics domestically or worldwide.

*U* will also benefit from MRC's ability to sign big stars without having to shoulder the cost for their paydays. MRC will pay the studio a flat distribution fee, as is typically the case for such arrangement.

The scope of the deal is noteworthy. Paramount's old deal with Marvel, for example, covered five pics.

*MRC* co-CEO Modi Wiczyk said the arrangement will enable to company to offer its creative partners greater choice and security. "It's a privilege to get a major studio distribution slot," he said. "You can count on one hand the names that have done deals like this," he added, citing Regency and DreamWorks.

*U* intends to use the deal to expand its slate. It will not cut into the number of pics the studio makes; the studio intends to produce and distribute the same amount of films each year.

*U* already plans to release the M. Night Shyamalan horror thriller, "Devil" for MRC. The studio also released Ricky Gervais' "Invention of Lying"
Value Claiming

Under output distribution contracts, the parties’ value claiming is generally relatively straightforward. The distributor deducts a distribution fee (typically in the 10 to 15% range) off the top from its gross receipts, then recoups its distribution investment advance (if any), and then all further cash flows to the producer.

In those cases, in which the marketing transactions are left with the producer so that the distributor only does licensing, the distribution fee is typically lower. That does of course reduce the distributor’s potential upside from the transaction, but distributors may still seek such contracts for at least two reasons: First, the additional movies released under such contracts may bring the total volume of movies released up to a level that is deemed optimal for the distributor’s licensing capacity, thus better utilizing the distributor’s resources, without requiring any further project-specific investments from the distributor. The outcome of this economies of scope and scale reasoning will of course depend on the full mix of the distributor’s acquisitions and output deals. This type of output distribution deal will for instance be particularly attractive to a distributor in periods with insufficient access to

Variety earlier reported on MRC’s financing and the background of its principals (Littleton & Schneider, 2008):

MRC is bankrolled through equity investments from a clutch of blue-chip heavy hitters including Goldman Sachs, AT&T, ad giant WPP and investment fund D.E. Shaw. [MRC principal] Wiczyk established key relationships in the industry and in the global finance community through his stint at Endeavor [a talent agency], where he specialized in setting up film financing projects for the agency’s clients. Satchu [MRC’s other principal] comes from a background in finance and launching Internet-based businesses.

Wiczyk emphasizes that MRC is not a private equity fund looking to make passive investments in film and TV production with a strict timetable for recoupment and profit disbursements.

MRC has "built a syndicate of investors who have both deep pockets and a deep understanding of our business," Wiczyk says.
internal or external funding for making its own project-specific investments (Fleming, 2008c; Goldstein, 2008a). Furthermore, utilizing capacity needs to be balanced against potentially creating situations in which the distributor’s movies compete against each other in cinemas (Harris, 2002b). Second, increasing the overall volume of movies through output distribution contracts may create value for the distributor more indirectly by increasing its market share. Jennifer, marketing executive at a major studio’s specialty division, comments:

Jennifer: [Parent distributor] would take on some of those projects for market share, so [movie franchise] isn’t something that we can make a lot of money on but it counts for the market share. So you want it to be successful, so the market share comes up...

TG: Why is that important?

Jennifer: Only because people think it’s important, because the trades write about it, and because it’s one of the measures that people look at from Wall Street. It’s not really important. Profitability is more important. But it’s like a rating. It’s one of those things...

Jennifer, President Marketing, major studio specialty division

Distributors may also agree to lower distribution fees in exchange for higher volume in the form of all rights deals (or split rights deals for a wide range of territories and media), in the form of a higher number of movies or in the form of higher profile and budgeted movies (event movies). Paramount, a studio distributor, reduced its distribution fee from 10 to 8% when expanding a contract with Marvel Studios, a producer, from a primarily domestic to a primarily worldwide deal. Marvel’s movies included in the deal were also high-profile event movies with high production budgets (see Box 6.19 above).

**Contracting**

When operating under an output distribution contract, the producer will have decision making control over all transactions from development through marketing, including the greenlighting decision. Even when marketing transactions are carried out by the distributor, which is most common also under these contracts, the producer will have the final word. This is not
uncomplicated for the distributor since the licensing transactions, which the distributor controls, need to be closely coordinated with marketing, as discussed in the previous chapter. Emilie, marketing executive at a major distributor, comments on her approach to marketing transactions when the producer has final say under an output distribution contract:

"I run a marketing department. It’s my job to open movies. So, I have to do the best job I can with whatever I have available to me... Clearly I feel it’s better if I control because that’s what my job is, as opposed to somebody else telling you “This is how much you have to spend.” Then you have to look at other things. I mean if it were less than you would spend were it your own movie and you could make the decisions, then you might look at the release date... You know, “Listen, if it were my movie I could spend x amount of dollars, I could put it out during the summer cause that’s when the kids are out of school, but they’re only giving me this much money to spend, so maybe I should go in the spring when there is not so much competition and TV rates are lower.” Those kinds of decision. You look what you have and then you try to make the best decisions."

Emilie, President Domestic Marketing, major studio

So while the producer may not have decision making control over licensing transactions, these will have to be adjusted to the decisions made for marketing, as for instance setting the release date (licensing) according to the advertising budget (marketing).

Under output distribution contracting, the distributor generally commits to distribute all movies provided by the producer that meet certain ex ante determined conditions (basically establishing the movies as fit for theatrical release). However, restrictions such as those described by Tom in Box 6.13, defining the minimum and maximum annual number of movies, are typically included to ease the planning for both parties. Hence, the producer also makes a commitment to delivering a certain number of movies for which they cover all production and distribution investments. Sometimes the scope of the contract is even more precisely set out, identifying the exact number of movies, the identity of the projects, approximate release dates, and so forth (see Boxes 6.20 and 21).
Like other forms of output contracts, output distribution contracts may be exclusive or non-exclusive. The contract described by Tom in Box 6.13 is exclusive, meaning that the producer cannot take any projects to other domestic distributors during the term of the contract. The contracts described in Boxes 6.20 and 6.21, however, are non-exclusive.

Most output distribution contracts are split rights deals, but they vary from those in which the distributor gets domestic rights only (Box 6.13) to others that may include most territories and media (Box 6.20), thus approaching an all rights situation. While the contract may cover extensive foreign territories, the producer will typically only cover domestic distribution investments.

In sum, when positioning output distribution contracting on the market-hierarchy continuum, it mostly resembles first-look contracting in that extensive decision-making control is given to one of the parties. This is the contractual reflection of that one party’s – the producer’s – commitment to cover both production and distribution investments. It may be argued that exclusive output distribution contracts are more integrated than non-exclusive ones, but here exclusivity limits the control of the party which is otherwise granted most of the control over the transaction. The positioning of output distribution contracting relative to other types of output contracting is indicated in Figure 6.8 below.

![Figure 6.8 - Positioning of output distribution contracting](image)

6.4 Layered Contracting and Production Studios

Sometimes a movie project may be subject to more than one vertical production-distribution transaction. A production company operating under an output distribution contract with a distributor may for instance acquire a movie from another producer using an outright negative pickup deal and then funnel this movie through its output distribution contract with the
distributor (Laporte, 2006a; Mohr & McClintock, 2006). Hence, a second layer of contracting is added. These vertical chains may also reach across more than two layers. Box 6.22 below provides an example with three layers.

In the Box 6.22 example, it is unproblematic to classify the companies at each end of the vertical chain as distributor (Warner) and producer (Emmett/Furla). The category of the two middle transaction parties is however more ambiguous and seemingly subject to which transaction layer one is looking at. Starting with the first transaction layer between Warner and Alcon, this is an output distribution contract in which Alcon is defined as the producer, supplying the movie and covering all the required production and distribution investments. The second layer transaction is an acquisition contract between Alcon and Millennium in which Alcon purchases a completed movie from Millennium. In this contract, Alcon would be defined as distributor since it is acquiring the distribution rights and Millennium as producer since it is the owner of these rights, as discussed in Section 6.2. Finally, the third layer transaction between Millennium and Emmett/Furla is a standard first-look contract in which Millennium is defined as the distributor and Emmett/Furla as the producer. Hence, the two middle transaction parties may be defined as both producer and distributor, depending on in which context of contracting layers it is seen.

<table>
<thead>
<tr>
<th>Box 6.22</th>
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<tr>
<td>Variety reports on the movie “16 Blocks” (2006, directed by Richard Donner) (McClintock, 2006b). The movie was produced by Emmett/Furla Films under a first-look deal with Millennium Films, which sold the movie to Alcon Entertainment, which channeled the movie through its output distribution contract with Warner Bros., which release it. Hence there are three layers of vertical production-distribution contracting involved:</td>
</tr>
<tr>
<td>1) Warner – Alcon output distribution contract</td>
</tr>
<tr>
<td>2) Alcon – Millennium acquisition (type not specified)</td>
</tr>
<tr>
<td>3) Millennium – Emmett/Furla first-look contract</td>
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</table>

Michael, who is head of a production company operating under a co-production financing contract with a major studio distributor, describes his
company’s role as a middle transaction party between the studio distributor and independent producers in layered contracting situations:

Michael: We’re [working on a] project-to-project basis too, but we’re not producing the films, producers come to us with the films. Independent producers come to us with the films or ideas and we decide what to finance. They’re basically the same, except we have more control over our destiny in terms of good and bad, and deciding which pictures to make, what to develop, who to hire, how to package them. We don’t have to wait around for the studio to say “Yes.” We do that.

TG: So... producers come to you with their projects. Do you also have deals with producers?

Michael: Yes.

TG: How do they work?

Michael: Same as the studio.

TG: Same as the studio?

Michael: Exactly.

TG: So you cover their overhead, they have to show you the projects, and...

Michael: Exactly the same as the studio.

TG: So in this sense you’re operating as...

Michael: A studio. Exactly the same.

Michael, Chairman and CEO, pact production company

To distinguish production companies like Michael’s, that also take this middle role in layered contracting situations from those that do not, these companies will henceforth be referred to as production studios. A production studio may be defined as a company that acquires, either via acquisition or output contracts, movies from producers that it does not itself distribute, but which are funneled through an output contract between the company and a
distributor. Also, the term “production studio” is sometimes, but not always, used for these companies in the industry trade journals. For instance, producer Hyde Park Entertainment, which has an output deal with Fox, a major studio, but also its own first-look deals with other producers, is described as “a studio within a studio” (Brodesser, 2005). Among the production studios covered in examples so far are Alcon, Millennium (Box 6.22), Media Rights Capital (Box 6.20), Dreamworks (Box 6.19), Relativity (Box 6.16) and Regency/New Regency (Box 5.1).

Generally, to operate as a production studio a company will need, first, financing to cover at least acquisitions and/or housekeeping payments and production investments, and second, an output distribution or co-production financing contract with a distributor. A first-look contract would not suffice as it would not provide for the necessary decision making control and it is generally not applied for companies with financial resources (then in fact it would typically become a co-production financing contract). Normally, a production studio would also not base the distribution of its movies on acquisition contracts, even though Media Rights Capital used only this strategy prior to signing an output distribution contract with Universal, which in this regard represents an exception (Box 6.21).

However, not all companies operating under an output distribution or co-production financing contract with a distributor are production studios. Some, like Marvel (Box 6.19), produce all movies in-house and do not contract other producers to fulfill its delivery requirements under its output contract, and is thus defined as a production company, not a studio. Only those that choose to use outside procurement through acquisition or first-look deals with other producers to fully or partly cover its slate are defined as production studios.

For producers seeking a distribution partner, either for an acquisition contract or for a first-look contract, the production studios offer an alternative to distributors. Consider a producer that has the option to contract either directly with a distributor or with a production studio operating under an output contract with the same distributor. If the producer contracts with the production studio it will not deal directly with the distributor of its movies, but only indirectly via the production studio. However, it may achieve greater flexibility with regard to distribution that way. Assuming that the distributor is not committed to release all movies from the
production studio, when the production studio likes one of the producer’s projects it will be able to offer production (and distribution) financing and at the same time shop it to a number of distributors should the production studio’s output distributor turn it down. The production studio may either add financing to a project package before pitching it to distributors, or alternatively, greenlight the movie prior to contracting distribution and then sell the project to distributors. Hence, from the producer’s point of view, the financing source would not be restricted and tied to the output distributor.

With layered contracting, one also sees alternative investment structures associated with the various forms of production-distribution contracting. Third-party investors may contract with production studios rather than distributors for both production and distribution investments, but those are the funding structures already covered for the producer’s financing in the two previous sections on co-production financing and output distribution contracting. With layered contracting, one may however see investors contracting further upstream in the vertical contracting chain to participate in movies that are eventually most likely destined for a particular distributor. One example is provided in Box 6.23.

In the Box 6.23 example the producer, Parkes/MacDonald, has a first-look contract with a production studio, Dreamworks, which again operates under an exclusive co-production financing contract with a distributor, Disney (see Box 6.19). Parkes/MacDonald then enters into a financing contract with a third-party investor, Imagenation. The financing contract provides funding for Parkes/MacDonald’s development transactions and gives Imagenation an option to co-finance production transactions, thus splitting the production investments with Dreamworks (see Figure 6.9). Hence, by contracting with Parkes/MacDonald, Imagenation will invest in movies developed and produced by this producer, greenlighted and co-financed by Dreamworks and distributed and co-financed by Disney. Had it instead contracted with Dreamworks, it would have participated in a broader range of movies developed by Dreamworks in-house or by any other producer operating under a first-look deal with the production studio. And had it contracted with Disney, the range would have been wider still, potentially including product from all the distributor’s acquisitions and output deals.

Generally, layered contracting offers an investor greater choice as to which level in the vertical chain it wishes to contract.
Box 6.23

The Hollywood Reporter reports on a third-party financier contracting directly with a producer positioned in a second layer output deal (Zeitchik, 2009a):

*With studios tightening their budgets, production banner Parkes/MacDonald has found a new source of funding -- Abu Dhabi's Imagenation.*

*As part of a new venture, the Middle East funder will pipe $10 million into Parkes/MacDonald development projects in a revolving fund, with the money replenished as it is used. Imagenation also will be given the opportunity to co-finance productions if the projects are greenlighted.*

*Parkes/MacDonald has a first-look deal with DreamWorks, so all projects from the Imagenation venture would go first to the Steven Spielberg-Stacey Snider studio. But any projects that DreamWorks passes on could be shopped to other studios, or produced directly with Imagenation. The venture, principals said, is for future projects only; it will not be applied to anything Parkes/MacDonald now has in development.*

*While the deal is being made specifically with Parkes/MacDonald, it creates associations that go beyond the banner. The venture indirectly extends the global relationships of DreamWorks, which is financed by India's Reliance Entertainment, to the Middle East. And it creates a link between Imagenation and Disney, which will distribute DreamWorks films domestically. [...]*

*The two entities will work together but with a clear division of responsibilities, principals said. "It's our intention to involve Imagenation, but we aim to provide the creative guidance as they are providing the financial backing," Parkes said.*

---

![Diagram](image)

**Figure 6.9 - Investment and production-distribution structure for Box 6.23 example.**
6.5 Cross-Case Overview and Summary

In Sections 6.2 and 6.3 above, detailed descriptions and within-case analyses were made for the vertical contracting cases, and then divided into sub-cases. While broadly similarly structured conceptually, only limited comparisons were made between cases. A more systematic cross-case analysis will better show relationships between cases and sub-cases, and thereby provide pattern clarification. While the next chapter in its entirety contains in-depth cross-case analyses of patterns related to project-specific investments, and a broader initial analysis is also made here to help summarize the cases. For this purpose, a case and conceptually ordered matrix is provided in Tables 6.1 and 6.2 below. This is the same matrix divided into two parts for acquisition and output contracting sub-cases respectively. Read vertically, the matrix also provides comparable summaries for each of the vertical sub-cases.

Each of the sub-cases outlined in the above matrix represents what the data indicate to be most typical. However, as seen in the previous sections on each sub-case, there are variations. Some contracts used in the industry will also be crossovers between the types defined here. One should therefore be careful reading a sub-case as being representative for any specific real-life contract in the same manner as one should be of seeing the archetypical citizen of any country as representative for any specific citizen of that country.
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Table 6.1 - Cross case analysis (acquisition contracting)
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<td>Producer / Distributor</td>
<td>Producer</td>
</tr>
</tbody>
</table>

<table>
<thead>
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<th>Value Creation</th>
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<tbody>
<tr>
<td>Revenue sharing</td>
<td>No</td>
<td>Horizontal and vertical</td>
<td>Horizontal (and vertical if advance)</td>
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<tr>
<td>Producer’s primary market</td>
<td>Distributors</td>
<td>Audience</td>
<td>Audience</td>
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<td>Producer’s fees and payments</td>
<td>Housekeeping</td>
<td>Production fee</td>
<td>Production fee</td>
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<tr>
<td>Producer’s backend</td>
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<td>Yes</td>
<td>Yes</td>
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<td>Distributor’s fees and payments</td>
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<td>Distribution fee</td>
<td>Distribution fee</td>
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<td>Distributor’s backend</td>
<td>Distributor retains all revenues</td>
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<th>Value Claiming</th>
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<td>Control – dev transactions</td>
<td>Producer / Distributor</td>
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<td>Greenlight</td>
<td>Distributor</td>
<td>Producer / Distributor</td>
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<td>Control – prod transactions</td>
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<td>Producer / (Distributor)</td>
<td>Producer</td>
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<tr>
<td>Control – distr transactions</td>
<td>Distributor</td>
<td>Distributor</td>
<td>Producer</td>
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<tr>
<td>Put pictures</td>
<td>No</td>
<td>Yes (in most cases)</td>
<td>Yes</td>
</tr>
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<td>P’s identity matters</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>D’s identity matters</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Transaction basis</td>
<td>Relational</td>
<td>Relational</td>
<td>Relational</td>
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</table>

* Excluding financial co-productions

Table 6.2 - Cross case analysis (output contracting)
6.5.1 Value Creation

For value creation, a pattern emerges from outright negative pickup contracting in one end to first-look contracting in the other. For acquisition contracting, both transactions and investments are clearly split between producer and distributor. And most so under outright negative pickup deals, in which the producer carries out all production transactions, covers all production investments and carries the production risk. The distributor carries out all distribution transactions, covers all distribution investments and carries the distribution risk. Pre-sale contracts for both acquisition sub-cases blur the line somewhat, as the contract is typically used by the producer as a safeguard to secure production financing from third parties (banks used in pre-sale financing). With pre-sale contracts, the distributor also takes on some production risk as it makes a commitment prior to production, either in the form of a purchase price or in the form of promises as to the width and thrust of its distribution. Acquisition distribution contracts also blur the line by the producer taking on some of the distribution risk through being compensated by revenue sharing rather than a fixed purchase price. If advances are used in these contracts, they will however more resemble outright negative pickup contracts in this particular regard, as discussed in Section 6.2.2. Within the acquisition contracting case, one may therefore see an outright negative pickup contract and a pre-sale acquisition distribution contract as polar cases, in which value creation is clearly divided in the first and more interdependent in the latter.

At the other end of the scale is first-look contracting. Here, production transactions are carried out by the producer and distribution transactions by the distributor, but all investments are covered by the distributor. Hence, both the production- and distribution risk are carried by the distributor alone. It is closely followed by output distribution contracting, which may be said to mirror first-look contracting. Production and distribution transactions are carried out by the producer and distributor, respectively, (though the producer sometimes also takes on marketing transactions), but here it is the producer that covers all investments, and thus carries both production and distribution risk. Distributors sometimes provide cash flow for distribution expenses, but producers are still responsible for these investments. These two sub-cases therefore represent the most integrated forms of contracting with the distributor and producer, respectively, as the main contributor to value creation.
The third output sub-case, co-production financing contracting, closely resembles pre-sale acquisition distribution contracting in terms of value creation. A nuance in production investments is that for co-production financing contracts the distributor will typically contribute more directly towards the financing (with an advance or direct investment), while its contribution under pre-sale acquisition distribution contracting is typically much more indirect (the contract is typically used by the producer as a safeguard for third-party investments). This nuance is then reflected in the distributor’s exposure to production risk, which under a pre-sale acquisition distribution contract is indirect through its distribution commitments, while under co-production financing contracting the direct exposure of its production investment is added to the distribution commitments. But apart from these differences related to production investment, the two sub-cases are very similar with regard to value creation.

Hence, looking at value creation, one may consider first-look and co-production financing contracting as the polar sub-cases under output contracting, and one sees that the least integrated output sub-case almost coincides the most integrated acquisition sub-case.

6.5.2 Value Claiming
Value claiming from the producer and distributor’s joint product is handled by the distributor as the downstream transaction partner through the collection of film rental and license fees (see Figure 5.1). As described in Sections 6.2 and 6.3 above, the producer’s share of joint value is claimed from the distributor in two basic forms, either as lump sum payments or through some form of revenue sharing.

Following the order of cases and sub-cases from the outright negative pickup contract as the polar sub-case towards the market end of the market-hierarchy continuum with the first-look contract at the other end, one sees that no revenue sharing is utilized for the polar contracting forms, but only in the middle forms. In outright negative pickup contracts (also for pre-sales), the producer’s value claiming is primarily in the form of a lump sum purchase price paid by the distributor. The producer also collects a lump sum production fee paid out of the movie’s production budget, but this is a relatively minor amount and represents standard practice across all contract forms. Once acquired, the distributor retains all revenues from its exploitation of the movie. In the other polar end for first-look contracts, the
producer receives housekeeping payments, typically drawn against its production fees, but since the distributor covers all investments, it also retains all revenues. Relative to a movie’s production budget, the producer claims less value under this contract form, but that is because it has no production investments to recover.

For the other sub-cases, revenue sharing is part of value claiming. First, in all these middle sub-cases, the distributor charges a distribution fee. Unlike the production fee, it is not a lump sum amount, but a percentage of the distributor’s gross receipts. Since the distribution fee therefore represents a horizontal revenue sharing mechanism, all of these sub-cases have an element of horizontal revenue sharing. In all of these sub-cases, in which the production and distribution investments are split between producer and distributor, there is also an element of vertical revenue sharing since a “last in, first out” principle seems to dominate, where distribution investments are recouped prior to production investments. The exception is the financial co-production type of co-production financing contracting (not included in Table 6.2), but there investments are also split horizontally, with each transaction party contributing to both production and distribution investments. The data also indicate that the most complex revenue sharing arrangements are found in the middle for acquisition distribution and co-production financing contracting, while the arrangements for output distribution contracting are simpler (primarily horizontal with a distribution fee only except when the distributor advances distribution investments).

As one would expect, a pattern thus emerges between value creation and claiming in which shared investments entail revenue sharing, and in which vertically shared investments are reflected in vertically divided revenues. The most market-like type of contracting, the outright negative pickup acquisition, represents the exception since the producer in effect is bought out of the project upon delivery and prior to release for the territories and media covered by the contract. But here the joint project investments are also shared in a non-integrated, non-coordinated manner more typical of market transactions. The upstream transaction partner creates a component to the joint product and sells it to the highest bidder, who uses this component as an input to complete the joint product. The buyer has no influence over the supplier’s investment and vice versa.
This brings us to the issue of what constitutes the producer’s primary market under the various contracting forms, which has not been explicitly addressed in the previous sections. The primary market is understood as the group of possible buyers that primarily determines the potential for value claiming. As was clearly illustrated by the “Happy, Texas” mini-case of outright negative pickup contracting, the value a producer may claim from its movie when using this form of contracting is not directly dependent on the movie’s performance among the movie consuming public, but on the purchase price a distributor will be willing to pay. And due to performance uncertainty, these are not always connected. Hence, under outright negative pickup contracting the producer’s primary market is distributors. Furthermore, as certain key film festivals represent key market venues and these festivals filter a small number of participating movies from a large number of submissions, thus determining market access for producers, one may also argue that these festivals indirectly represent the primary market since failure to gain access is likely to significantly reduce the potential for value claiming.

Again, a similar situation is found at the other polar end sub-case of first-look contracting. Also here, the scope of the producer’s value claiming is dependent on the distributor and not directly on the audience since there is no revenue sharing. The producer’s housekeeping payments are determined in a contract potentially covering a number of movies entered into by the parties prior to the commencement of any work on these projects, and thus of course with the performance of these projects being unknown. As shown in Section 6.3.1 above, there are however some fairly common exceptions in which the housekeeping payments are drawn against a producer’s share of the distributor’s revenues. In these cases, the producer will see additional payouts if its share of revenues exceeds housekeeping payments received so here the producer’s primary market would consist of both the distributor and audience.

For all other sub-cases, the producer’s primary market is made up of both distributors and audience. If the producer’s revenue share is small, the distributors will dominate (e.g. an acquisition distribution contract with a substantial advance), and if the share is large the audience will dominate (e.g. an output distribution contract with a low distribution fee).

A pattern thus emerges with regard to the producer’s primary market, in which the producer looks to distributors in the polar sub-cases of outright
negative pickup and first-look contracting, and to audiences in the middle sub-cases. However, the polar cases are not alike. Under outright negative pickup contracting, the producer looks to distributors as potential market buyers, while under first-look contracting it looks to distributors more as potential “employers,” to borrow the terminology of the interviewees.

6.5.3 Contracting
The primary difference in contracting between acquisition contracting and output contracting is that in the first the contracting is done on a movie-to-movie basis, while under the latter it is done for a slate of movies (an output) defined either by a specific number of movies, a specific period of time or by both. Hence, under acquisition contracting, the transaction parties will search, negotiate and contract for a specific project, while under output contracting, an alliance is established between the transaction parties ex ante under which the individual projects are carried out.

In terms of the horizontal dimension of split- or all rights contracting the data indicates that both may be combined with all vertical cases except first-look contracting, which seems to always be of the all rights type. First-look contracts with split rights referred to in the data turned out to better defined as co-production financing contracts (which in the industry are sometimes referred to as just first-look deals). The pattern is therefore that the most integrated vertical case is also horizontally integrated, while the less integrated vertical cases may be more horizontally diverse.

For the allocation of decision-making control between the transaction parties, there is a fairly clear pattern in which it reflects value creation contributions (particularly investments) across the cases and sub-cases. The most unified control is found in first-look and output distribution contracts, in which the decision making control for all transactions rests almost entirely with either the distributor or producer, respectively. For co-production financing contracting and pre-sale acquisition contracting, control is shared between the parties in a way that typically reflects how production and distribution risk is shared, with one exception: Producers are typically not given any control over distribution transaction beyond any minimum commitments by the distributor negotiated in the contract, even when sharing the distribution risk. For other acquisition contracting, control generally rests with the producer ex ante and the distributor ex post contracting, but again the distributor typically makes certain commitments
with regard to the distribution transactions under acquisition distribution contracting, thereby reflecting the producer’s share in the distribution risk.

One important commitment from the distributor to the producer under output contracting is the promise to in fact release some or all of producer’s a movies even though these are not identified ex ante, allowing for put pictures. And the pattern is again that it follows value creation contributions, particularly investments. Under first-look contracts in which the distributor covers all investments, no put picture provision is included, while under output distribution contracting in which producer covers all investments, such provisions are required as an additional safeguard for the producer’s investments. Under acquisition contracting, put picture provisions are generally not applicable since the contracting is done on a movie-to-movie basis (one may of course argue that there is an implicit put picture provision for the movie contracted), but as seen in Boxes 6.7 and 6.10, there are some rare exceptions in which put pictures are added to enhance the distributor’s offer.

Finally, while not discussed systematically and explicitly under every case and sub-case in the sections above, a cross-case pattern also appears as to the significance of each transaction partner’s identity. Only under outright negative pickup contracts made following completion does the identity of either party seem important. The festival bidding situations are typical for this type of contracting (see Box 6.4). These transactions resemble “ideal” market situations in which faceless sellers put up products for sale, for which information (on quality, etc.) is transparent, while faceless buyers place their bids and the price mechanism determines which seller and buyer transacts. If the same outright negative pickup contract is made as a pre-sale, however, the producer’s identity will matter to the distributor. In Section 6.2.1 Julia, a marketing executive at a mini-major distributor, says that “the scariest thing for a distributor would be to collab with an untested director, untested producer and untested filmmakers in general with the concept on paper and then asking for financial commitment.” If asked to make a commitment prior to production, the distributor will seek an experienced producer - someone who has “played in this sandbox many times before and gotten it,” as Julia puts it. The distributor’s identity will however not be similarly important to the producer since there is no revenue sharing, making the producer’s value claiming dependent on the distributor’s performance. Generally, the
producer only needs to be confident in the distributor’s ability to pay the lump sum purchase price upon delivery.

Under acquisition distribution contracting the distributor’s identity is more important to the producer. The producer’s value claiming is dependent on the distributor’s performance of the distribution transactions. It becomes important for the producer to find a distributor that sees the movie “eye-to-eye” with the producer and shares the “same level of excitement” as George, an independent producer, puts it in Section 6.2.2. And again, if the contract is made as a pre-sale, the producer’s identity becomes important to the distributor.

For all forms of output contracting, both parties’ identity will matter since the contracting is not made on the basis of specific product. The contracting is instead done on the basis of the parties’ identity, typically with an emphasis on each party’s experience and track record with production and distribution transactions respectively.

The pattern emerging is therefore one going from the insignificance of identity for the most market-like sub-case to turning immediately more important when moving towards the middle sub-cases and being significant for both parties in the most integrated from of acquisition contracting and all forms of output contracting.

While the data indicates that identity is important for all except the most market-like sub-case, it also indicates that the underlying variable causing identity to become a factor is uncertainty. Julia speaks of untested producers in the same context as untested talent. And it is clear from her statements that when preferring a tested producer for pre-sale deals, it is for the same reason as when packaging a project with tested talent: to reduce ex ante performance uncertainty. When George chooses a distributor that shares his level of excitement and sees the movie eye-to-eye with him, it is because this reduces his perceived ex ante performance uncertainty on the distributor’s end. He believes this distributor will be less likely to underperform in its distribution transactions for the movie, which he relies on both for his immediate value claiming from the particular movie and for his continuous reputation as a successful producer. And when the producer of the Case Title movie in Box 6.8 chooses the Case Studio, it is because it perceives the ex
ante performance uncertainty for the particular distribution transactions required for the Case Title to be lowest with that particular distributor.

6.5.4 Sub-Case Positioning
To sum up, the sub-cases specified in Tables 6.1 and 6.2 may be placed on the market-hierarchy continuum approximately as indicated in Figure 6.9 below. Under acquisition contracting, the producer and distributor transact on a movie-to-movie bases while they under output contracting form alliances under which the project transactions take place. Yet, the above analysis shows that in certain aspects (value creation and claiming), a co-production financing contract may more closely resemble a pre-sale acquisition distribution contract than a first-look contract. Similarly, a pre-sale acquisition distribution contract may more closely resemble a co-production financing contract than an outright negative pickup contract.

![Figure 6.10 - Cases and sub-cases approximate position on a market-hierarchy continuum](image-url)

"Figure 6.10 - Cases and sub-cases approximate position on a market-hierarchy continuum"
7 Empirical Contracting–Investment Relationships

This chapter will address the various empirical relationships between contracting and project-specific investments found in the data. Since these relationships are identified by looking at how variations in contracting form affect investments, the analysis is as such primarily of a cross-case type. Relationships are presented thematically and conceptually ordered as illustrated in Figure 7.1 below. In the first section, relationships between vertical contracting and project-specific production and distribution investments are discussed. The next three sections add relationships with star talent and reputation, with coordination and with horizontal contracting, respectively. Finally, in the last section all identified relationships and the interactions between them are summarized.

Figure 7.1 - Chapter structure (sections in parentheses)

7.1 Contracting and Project-Specific Production and Distribution Investments

This section discusses the relationship between production and distribution investments. First, how the two correlate and create joint value for the transactors; second, how distribution investments depend on production investments; third, how contracting balances the risks between the two types
of investments; and finally, how production investments relate to distribution investments via contracting.

7.1.1 Production Investments, Distribution Investments and Joint Value

As established in Chapter 5, almost all production and distribution investments are project-specific. Hence, a fairly good picture of the balance between project specific investments into production and distribution transactions is provided by statistics on the average negative (production) and domestic marketing (distribution) costs for movies released theatrically. Average investments in movies released by the major studio distributors (Motion Picture Association of America members⁴), including mostly higher budgeted movies given wide releases, are shown in Figure 7.2 below. Over the seven-year period covered here distribution investments are on average relatively stable at approximately 50% of production investments. However, as discussed in Chapter 5, the numbers will vary for individual movies, particularly so for those with lower production costs for which distribution investments may reach levels many times as high as that of production investments. Such variance is reflected in the numbers shown in Figure 7.3, which covers movies released by the major studio subsidiaries and affiliates.⁵ These are the specialty divisions that mostly handle lower budgeted arthouse and genre movies. Also here, the seven-year average distribution investments end up at approximately half the production investments, but the variations are greater from year to year. This is mainly due to a greater variance between movies, which makes any year’s average more dependent on which particular movies were released that year. A “The Blair Witch”⁶-like movie (see Section 5.4.2) will greatly affect the averages, with lowering production costs and hiking distribution costs. The low was in 2001, when the average distribution investment was less than one-third of the average production investment, while the high 2005 distribution average was almost two-thirds of the production average that year. Similar numbers for movies released by independent distributors are not available.

⁴ Paramount, Sony (Columbia Tristar), Twentieth Century Fox, Universal, Walt Disney, Warner Bros.
⁵ Such as Fox Searchlight, Miramax, New Line, Sony Pictures Classics, etc.
Figure 7.2 - Average production and distribution costs in million dollars for MPAA-member theatrical movies 2001-2007 (the most recent period for which such figures are released) (MPAA, 2008)

Figure 7.3 - Average production and distribution costs in million dollars for theatrical movies 2001-2007 from MPAA-member affiliates/subsidiaries (the most recent period for which such figures are released) (MPAA, 2008)
In the context of joint value creation, Figures 7.2 and 7.3 may be seen to illustrate how the average project-specific investments made into production and distribution transactions for these movies create joint value represented by the total height of each column. The relationship between total joint investments and joint value is however more complicated, and one should be careful not to understand joint investments or joint value as equal market value of the joint product. First, the producer and distributor may contribute to value creation in ways that are not always well reflected in the amounts invested since the productivity of invested funds will vary. For instance, a positive discrepancy between value and investments may occur when a producer is able to hire star talent at rates below their typical market rate (see Box 6.5) and a distributor may identify and narrow in on a target audience, thus achieving more productive use of its marketing investments (see Box 7.1). Similarly, negative discrepancies may simply occur from overpayments or poorly executed production and distribution transactions. More broadly, as discussed in Chapter 5, the performance uncertainty of any production and distribution transaction is likely to create positive and negative discrepancies. Second, due to the high ex post performance uncertainty related to a movie’s ultimate market reception, the joint value will often be significantly higher or lower than market value (see Box 7.1). Hence, total joint investments should only be seen as a *ceteris paribus* proxy to joint value, and joint value may not equal the joint product’s market value.

### 7.1.2 Production Investment Effects on Distribution Investments

In Box 7.1 below Tom, COO at a major studio, discusses the relationship between production and distribution investments and concludes that the two tend to correlate, which fits the picture emerging from Figures 7.2 and 7.3. However, he is careful to point out that they correlate not according to any informal industry rule or practice based on a fixed ratio between the two, but because distribution investments are based on an assessment of each movie’s elements and their market potential. And generally, elements and market potential justify higher distribution investments for movies with higher production budgets. Sometimes, based on a positive assessment, distributors decide to invest more than an average ratio to production costs would indicate, while at other times they will decide to spend less based on a negative assessment. Assessments may take place at any stage, e.g. prior to production (assessing marketability based on a package), upon viewing of
the completed movie (assessing playability) and during the release (assessing market reception via tracking and exit polls). The assessments made up until the release will basically be of the value created from production investments, and since the value will be a ceteris paribus function of investments, it follows that distribution investments will be dependent on production investments, as illustrated in Figure 7.4 below.

![Figure 7.4 - Relationship between production and distribution investments with product uncertainty as a moderating variable](image)

**Box 7.1**

Tom, COO at a major studio, comments on the relationships between investments and value, and between production and distribution investments:

*Tom:* When we finished [Title of a somewhat underperforming movie], and then put the P&A in, you could say the movie cost 110 million dollars if you add P&A to the cost of the negative... or more like 120 million dollars. Was that the value of the movie? An accountant would say no, it’s cost or market, whichever is lower. I would have sold it that day for 100 million. Not 120. So no, you got to be careful with the word “value”.

[...]

*TG:* I would expect that if there is movie of a certain size... or negative cost, then it should be matched to a certain P&A level, or is that not the case?

*Tom:* It tends to work out that way, but not for the reason you would think. Implicit in your question is the thought that someone would say “this movie cost
100 million dollars, so gosh, we have to spend - for a 100 million dollar movie we have to spend 40 in P&A and everything else to really get it out properly. “It sort of makes sense. But what actually happens is that because we spend a 100 million dollars, we have certain elements in the movie: major movie stars, major special effects, major this and major that, and it has a certain size to it. Because of its size we have so much in the negative that we think “you know what, we really have to have a big opening weekend because if we do not open the picture strong we run the risk of losing a lot of this money.” Because all of the money you expend, whether negative or P&A, is money at risk. So we would rather not spend an incremental dollar in P&A and put it at risk if we didn’t have to. So if the picture cost 50 million instead of the 100, I might say “You know what, I don’t want to spent 40 because suppose it’s a bomb, so I do not want to take the risk, because we don’t have to do that much money to come out on a 50 million dollar movie so lets have a P&A budget of 35.” Also the elements of a 50 million dollar picture don’t demand as wide a release, as many prints, as big an impression in the marketplace because it is a smaller movie. And so... it can take a little time to find its audience. Its ok, we are not at risk that much. But the two do tend... the two do correlate. So the more money we spend on the negative cost, the more money we are likely to spend in the P&A. True. Sometimes the reverse will happen. We have a little movie called [Title 1] coming out next [date] with the singer [artist name]. It’s really an inexpensive movie. But she is so popular among young girls of 8 to 16 that we thought to ourselves: “We may have an upside here if we really advertise heavily to that group.” So we are spending more money than we did releasing [Title 2], which is a drama that cost more than twice as much, still not expensive. Cost about 22 million dollars, but more than twice as much as this other [Title 1], which is like a 10 million dollar movie. And the reason is that we think that we have a real marketing opportunity with the [artist name]-picture that we don’t have for [Title 2].

Tom, COO, major studio distributor

7.1.3 Contracting: Balancing Uncertainty between Investment Decisions
At the outset, investment decisions for a movie may be seen as sequential decision making on progressively sunk costs, as suggested by Caves (2000), and as such, a type of the adaptive, sequential decision-making problems central to TCE (Williamson, 1985). Costs are sunk because investments are project specific. The further downstream in a project’s value chain a decision is made the more information will be available, so uncertainty is declining. Generally then, production investment decisions will be made under greater
uncertainty than distribution investment decisions. The uncertainty of a
distribution investment decision will very much depend on the degree of
product uncertainty still present at the time it is being made. If a
commitment is made upon greenlight, uncertainty will equal that of the
production investments made at this point, while product uncertainty will be
eliminated completely if the decision is made following completion. The
degree of product uncertainty may be seen as a moderating variable on the
relationship between production and distribution investments since to a
varying degree it will affect the distributor’s ability to assess the value
created by production investments.

As seen in the previous chapter, contracting measures may be taken by the
parties towards balancing uncertainty between them. If contracting is used to
balance uncertainty, a trade-off is agreed upon, whereby the production
investment risk is reduced at the expense of a higher distribution investment
risk. A review of how the various contracting forms rebalance uncertainty
shows how producer’s and distributor’s investment risks are affected,
starting with those types that do balance risk before discussing the type that
does not.

Under pre-sale acquisition contracting, distributors make commitments prior
to production, thus increasing the uncertainty for their own investment
decisions while decreasing uncertainty for production investment decisions,
as production investors then obtain these commitments regardless of the
quality of the completed movie (provided it meets certain technical
standards). Producer’s incentives to contract early, i.e. to obtain a pre-sale
acquisition, and distributor’s incentives to avoid pre-sale contracting, which
follow accordingly, were clearly stated by the interviewees (see Section
6.2.1). However, while distributors make commitments prior to production,
and thus prior to assessing a movie’s playability, they may make upwards
adjustments to these decisions upon reviewing the completed movie (see
Julia’s’ comments on minimum commitments in Section 6.2.2). Hence, there
will still be elements of sequential decision-making. Downward adjustments,
however, are ruled out as they would undermine the commitment. Tom,
COO at a major studio distributor, comments:

Tom: Once we get passed the minimum – we’ve already committed
to a minimum – once you get passed it you may spend nothing.
TG: But the minimum you will always have to do?

Tom: That’s your deal.

Tom, COO, major studio

Under co-production financing, output contracting the mechanisms are similar, but the distributor’s commitments will typically be less formal and rather take more of a relational character. Michael, head of a production studio operating under a co-production financing contract and former chairman and CEO of a major studio, who has handled these contracts from both sides of the table, comments on the distributor’s final control over distribution decisions, including the distribution investment decisions:

Many of these things they have final control over but they have to exercise it very carefully too. Because you’re the supplier of the product, and they don’t want to make you feel like they’re not your partner.

Michael, Chairman and CEO, pact production studio

Furthermore, under many co-production financing contracts, the distributor will also be a production investor, and the production and distribution investment decisions will therefore be partly integrated with the same decision maker.

Both first-look and output distribution types of output contracting have production and distribution investment decisions integrated with a single party, the distributor and producer respectively, and balancing uncertainty between parties by reducing production risk at the expense of distribution risk is thus not an issue.

Non-presale acquisition contracting, on the other hand, has no balancing mechanisms for reducing production investment risk. As always, the production investment decisions are made by the producer under significant product uncertainty since the full production budget has to be committed upon greenlight, but here the distribution investment decisions are made by the distributor after the completion of production at a point when product uncertainty has ceased. Hence, when the production investment decisions are made, there is not even a commitment to distribute the movie. The number of theatrical distributors is limited and the number of theatrical distributors
with resources to provide a movie with a wide release is even more limited. Therefore, when a theatrical movie is greenlighted, the producer slips into small number bargaining for distribution. If the movie has a higher production budget that requires a wide theatrical release to recoup investments, the number will be even smaller. One agent comments to Variety: “[The studio distributors’] attitude is: Producers need us because they only have five other places they can go” (Harris, 2004). A fundamental transformation (Williamson, 1975) therefore takes place upon greenlight even if no distributor is contracted, establishing a bilateral relationship. Another level of specificity is added beyond the project specificity since the value of the assets created by the production investments is not only reduced outside the context of the project, but also outside the context of a potential future contract with one out of a few distributors. Ryan, marketing and distribution executive at a larger independent production company, says:

“Production financing 101” in film business would say “You do not start shooting a movie unless you have a US [distribution deal].” And we are not talking about these little one or two or three million dollar movies, we know they are not going theatrical, they’re going straight to home video and TV. We’re talking about what’s called pictures that are theatrically driven. [...] There was this Whoopie Goldberg’s called “Theodore Rex”, the Whoopie Goldberg-movie years ago, it was like a 35 million-dollar movie. And they started shooting; it was financed without a US deal. [...] And it ended up they couldn’t sell it. It got screened and there’s no [theatrical] buyer for the US. Went right to home video. So somebody lost a lot of money - a lot of money.

Ryan, President Worldwide Marketing & Distribution, independent production company

7.1.4 Production Investments’ Dependence on Distribution Investments and Contracting

It follows from the above discussion that not only are distribution investments dependent on production investments, but there is also a reverse dependency between production and distribution investments. And since these investments are primarily made sequentially, this relationship also involves contracting. There are generally two major concerns in terms of this relationship. First, provided the production budget is at a level where a
theatrical release is deemed necessary to realistically recoup investments, the production investment risk will be significantly higher when no distributor is contracted prior to greenlight. If, as in Ryan’s “Theodore Rex” example, no distributor is later willing to commit to the investments necessary for a theatrical release much of the production investments are likely to be lost. This is a channel uncertainty issue, but related to distribution, not exhibition, access. Second, as shown above, distribution investments are adjusted to the elements created by production investments and the two therefore tend to correlate. While not all elements are known upon greenlight, the elements necessary to assess marketability usually are. If production investments are made into expensive elements such as star talent, these may be matched with certain distribution commitments which, as we have seen, will typically be in the form of a minimum width of the release and a minimum marketing investment. These commitments reduce production investment risk, as the producer is not only ensured market access (less channel uncertainty), but also a certain level of value creation on the distribution side of the joint product (less distribution performance uncertainty). Without contracting providing such balancing between production and distribution investment risk, the production investment risk may become prohibitively high, especially for higher budgeted movies. Ryan adds:

*You need to sell the US especially to really put the financing together. Unless you are... There are certain companies obviously that can take that risk. But it’s a risk you don’t wanna take.*

Ryan, President Worldwide Marketing & Distribution, independent production company

These statements from Ryan should be seen in the context of his other statement, in which he says that 80% of the movies made do not turn out as expected, quoted in Section 6.2.1. The underlying product uncertainty is thus the source of channel uncertainty. If the producer and production investors could be certain that a movie would turn out well, the small number distribution bargaining would be less of an issue. Brad, CEO of an independent production company, is more explicit and specific about channel uncertainty and the production investment risk:

*High budget pictures are seldom produced without having a North-American distribution deal in place – the risk is too high. It happens,*
but very seldom. If it happens, like in the case of Gaumont’s “The Fifth Element”, it is usually a strong company on the production side that can carry large risks. Also, in this case they had a top cast attached, including Bruce Willis, so you knew you would get a North American deal. But, I would not do it this way. But, they are French – they do things different, I guess.

Brad, CEO, independent production company

The variance in how production-distribution contracting is used to balance uncertainty, and thus investment risk between production and distribution is reflected in the producer’s primary market row of the cross-case matrix presented in Tables 6.1 and 6.2. For outright negative pickup contracting distributors represent a producer’s primary market, as its value claiming is not dependent on a complete joint product. Here, the producer sells a component, the movie itself (the completed production transactions) to one out of a small number of distributors, and its value claiming depends on the distributor’s value assessment of that component. Under first-look contracting, the producer’s primary market is also distributors, but for a very different reason: The producer does not make any production investments and looks to the distributor as an “employer.” The production investment risk is carried by the distributor and the decision making is internalized. For all other forms of contracting, the producer’s primary market is the audience (for generating joint value) and distributors (for negotiating the most favorable share of that joint value), which means that some degree of contractual balancing between production and distribution investment risk is present.

From the above, a pattern between production and distribution investments and contracting emerges: There seems to be a fairly direct relationship between contracting and production investment via distribution commitments and uncertainty (see Figure 7.5 below). For production investments, one seeks safeguards in distribution investment commitments to ensure that a complete joint product will materialize. For a complete joint product, one is dependent on sufficient project-specific investments to carry out all required transactions throughout the project’s value chain, and as established in Chapter 5, the transactions requiring substantial specific investments are located in the production and distribution stages of the chain. Without a complete joint product, value creation will collapse since
there is a mainly multiplicative production function between elements (Caves, 2000), and value claiming will subsequently suffer and increase the likelihood of investors having to take losses on their investments. Any contracting form providing distribution commitments reduces channel and distribution performance uncertainty, which encourages production investments.

However, other variables also affect this relationship between contracting and specific investments. Product uncertainty is the source of channel uncertainty, so the greater the product uncertainty, the greater channel uncertainty. Budget, or the size of the required production investment, also seems relevant since distribution commitments are considered less important for production investments into lower budgeted movies. These movies are less dependent on a theatrical release and will thus have wider distribution options. Therefore, producers are not subject to the same level of small number bargaining for the distribution of these movies as for the higher budgeted movies, so one may then argue that the specificity of these production investments is lower.

![Figure 7.5 - Relationships between contracting, commitments, channel and distribution performance uncertainty and production investments with product uncertainty, budget and asset specificity as moderating variables](image)

Figure 7.5 - Relationships between contracting, commitments, channel and distribution performance uncertainty and production investments with product uncertainty, budget and asset specificity as moderating variables
A relatively novel but interesting mini-case is the production and distribution of the movie, “What Just Happened” (2008, directed by Barry Levinson), a movie that may be categorized as mid-range, with a production budget estimated at USD 25 million and stars including Robert DeNiro, Sean Penn and Bruce Willis (IMDbPro, 2012d). The movie was handled as a non-presale acquisition by its producer, 2929 Productions, and was first shown at the Sundance festival, though without finding a buyer. It was then shown again at the Cannes festival later the same year, but again without being sold for domestic distribution (Goldstein, 2008b). Ultimately, it was released theatrically in North America by Magnolia Pictures, which is the distribution arm of 2929 Productions. So production and distribution ended up closely integrated, but with a release through a much smaller and less resourceful distribution company than what was originally envisioned. Data on distribution investments are not available, but since the movie was pushed for a domestic acquisition at two major festivals it is reasonable to assume that these were low compared to what the producer had expected when the greenlight decision was made. The width of the release never reached more than 88 screens, and the domestic box office gross stopped at just above one million dollars (IMDbPro, 2012d). The producer may have seen its own distribution company as a fallback position for distribution when deciding to greenlight the movie without any other domestic distribution commitments. However, the mini-case underlines producers’ small number bargaining situation, as it is not only an issue of securing theatrical distribution, but to get the necessary commitments from a distributor with the capacity and resources to provide distribution investments that match the scope of a movie’s production investments. This particular case is novel because the production company also has a distribution arm, but the basic structure of the project and its faith is common enough to have earned the label MFNs (movies for nobody) in the industry (McNary & Garrett, 2007). These are theatrically driven movies made for acquisition contracting that fail to find a domestic theatrical distributor, like Ryan’s “Theodore Rex” example above.

7.1.5 Interdependent Investments

In sum, the relationship between production and distribution investments will typically be interdependent. Distribution investments are based upon assessments of the value created by production investments, and production investments may be dependent on distribution commitments. The latter dependency will be stronger for higher budgeted movies requiring wider
theatrical releases and weaker for lower budgeted movies less dependent on a theatrical release to recoup their production investments. Furthermore, investments depend on contracting. Provided a movie has a certain size and thus requires a theatrical release – and these are the movies with which this study is concerned – contracting forms that balance production and distribution risk through distribution commitments encourage production investments (see Figure 7.5) and therefore indirectly also distribution investments (see Figure 7.4).

7.2 Stars, Reputation, Contracting and Investments

This section extends the relationships between contracting and investments to also include star talent, attractive material, reputation and contract uncertainty. It first focuses on how the presence of stars affects investments and how their presence depends on investments, then expands to also include reputation and contracting in these relationships. A similar analysis is then made for attractive literary properties, and finally, the effects of contract uncertainty in these relationships are discussed.

7.2.1 How the Presence of Star Talent Affects Investments

In his comment on channel uncertainty in Section 7.1.4 above, Brad says that “in this case they had a top cast attached, including Bruce Willis, so you knew you would get a North-American deal,” thereby suggesting that star talent reduces channel uncertainty. In view of Ryan’s Whoopi Goldberg example, Brian’s use of the word “knew” may be seen as a bit strong, but the argument seems to be that the likelihood of obtaining sufficient distribution is significantly increased when star talent is involved. From the discussion of the packaging transactions (Section 5.3.1) we know that the objective of these transactions in which star talent is attached to a project is to reduce product uncertainty. A top cast, as in Brad’s example, reduces product uncertainty with regard to the quality of its performance (affecting the movie’s playability) and possibly even more so with regard to its value as a marketing tool (affecting marketability). Jennifer, marketing executive at a major studio specialty division, explains the importance of the latter when financing a movie’s production investments:

You get trapped, because if you spend 8 million dollars making a movie and it doesn’t turn out so good, you’re gonna loose 8 million dollars unless you figure out some way to get out from that. So what
we try to do is often back ourselves up, that even if this movie
doesn’t turn out to be executed that well, it’s got something in it that
we can sell. So, it’s got a story-line that is interesting or it’s got a
star that is interesting or two stars that are interesting or a director
who is a name director - so that we, in marketing, have something to
work with even if the movie itself doesn’t turn out so good. And then
we would try to find a way to come out at least even on it.

Jennifer, President Marketing, major studio specialty division

It may hence be argued that the relationship between star talent and channel
uncertainty suggested by Brad is not direct, but indirect via product
uncertainty. Furthermore, from Jennifer’s statement, it is apparent that it is
not only an issue of reducing channel uncertainty, but also of distribution
performance uncertainty; star talent gives her something to work with in
marketing even if the movie itself does not turn out well. In Jennifer’s case
there is in fact no channel uncertainty with regards to distribution since here
the distributor is financing production investments and thus contracted prior
to production. Nonetheless, she will face channel uncertainty with regards to
exhibition, as illustrated in Box 5.6. The issues of channel and distribution
performance uncertainty are of course interlinked. One may say that it is
because product uncertainty affects distribution performance uncertainty that
distribution channel uncertainty arises. If a distributor sees that it may not
have anything to work with for marketing, it is less likely to get involved in
a project, and exhibitors will not be interested in a movie for which the
distributor cannot provide proper marketing.

In sum, star talent reduces product uncertainty which again reduces channel
and distribution performance uncertainty, as shown in Figure 7.6 below.
Moreover, as discussed in the previous section, reduced channel uncertainty
encourages production investments. This extends the relationship from star
talent to also include production investments. Distribution investments are
not included in this figure, but as discussed in the previous section they are
positively affected by production investments and star talent is among the
key elements assessed when distribution investment decisions are made.
This is a reoccurring pattern in the data. The relationship between star talent and production investments is stressed by Johnny in Box 6.5 when he explains how he finances a movie under outright negative pickup deals: “And when you make a movie like that, you tell [investors] up front that the leads, in our case, are [star actor 1] and [star actor 2]. They’re in the movie and that’s all they care about… is that those two people are in the movie. And the rest… – ‘whatever.’”

Furthermore, investors sometimes target star talent directly for production investments. As discussed in Section 5.3.1, star talent often has ownership in production companies which they use to develop projects that are of particular interest to them, and many of these production companies have output deals, most often first-look deals, with studio distributors or production studios. Instead of investing directly with a studio distributor or production studio, investors sometimes contract directly with the star talent’s production company, thereby more specifically targeting their investments, as discussed in Section 6.4. An example involving a foreign investor, Reliance, and a number of star talent production companies is provided in Box 7.2.

Box 7.2

Variety reports on financing agreements between Reliance Big Entertainment, India’s largest entertainment company, and a number of production companies controlled by Hollywood star talent (Frater, 2008):

Reliance has signed a string of development deals with the production shingles of a stellar array of top Hollywood talent: Nicolas Cage’s Saturn Prods., Jim Carrey’s JC 23 Entertainment, George Clooney’s Smokehouse Prods., Chris

Figure 7.6 - Relationships between star talent, product, channel and distribution performance uncertainty and production investments
In the Reliance case the investor seeks out, with the assistance of a major talent agency, established star talent with production companies that already have first-look distribution contracts (see Figure 7.7 below). Offering these companies development financing, it acquires an option to participate in up to half of the production financing for any of these developed projects the studio decides to greenlight, with the studio covering the balance under its first-look contract. In effect, the investor turns the first-look contract into a co-production financing contract that provides more control and influence to the star talent. For the investor, these contracts offer safeguards that reduce uncertainty in a number of ways. First, they allow the investor to handpick talent in which it believes. Second, they only commit the investor to development investments, which are relatively modest compared to a
project’s total costs. While the investor has an option to participate in the production investment, it is not a commitment, and the investor will therefore have the opportunity to assess each project’s package before making a production investment commitment. Should the star talent choose not to participate in a project personally, the investor is not committed to invest. Hence, and third, if the investor chooses to participate with a production investment, product uncertainty is reduced by the participation of the star talent, which also reduces distribution performance uncertainty. And finally, there is little channel uncertainty for any of these projects since first-look contracts are already in place. The production investor thus benefits from both distribution contracting, discussed in Sections 7.1.3 and 7.1.4 above, and star talent participation, discussed here.

Another talent-driven approach is taken by investor Media Rights Capital (MRC). As in the Reliance case this investor also targets production investment projects through talent, but unlike Reliance it does not choose talent already working under first-look contracts with studios. Also, it is primarily targeting directors, not actors, but as discussed in Section 5.3.1, top directors will typically attract top actors. MRC’s proposition to attract talent is asking them to “forgo the big upfront payday that is the norm for major studio development pacts in exchange for more creative latitude, the flexibility to sell to any outlet and most important, a larger ownership stake in the final product” (Littleton & Schneider, 2008). Hence, projects are sold to distributors using acquisition contracting on a movie-by-movie basis, and since all projects contain “bankable talent” (Littleton & Schneider, 2008), the investor does not insist on the acquisition contracts being made as pre-sales. “With our deep capital base, we have the luxury of not having to pre-

Figure 7.7 - The contracting structure of the Reliance case (Box 7.2)
sell all our films. We have the ability to select the appropriate and optimal deal and distributor for each territory, each media and each project,” MRC-principal Modi Wiczyk says to Variety (Fleming, 2007). The copyright ownership share offered to talent is meaningful and valuable because MRC typically contracts relatively short licenses with distributors (15 years), after which the exploitation rights revert to the copyright owners who are then free to resell the movie to the same or a different distributor. The initial investment and distribution strategy of MRC thus heavily leans on star talent to reduce channel uncertainty, resembling the Gaumont-strategy that Brad is quoted as advising against in Section 7.1. However, as quoted in Box 6.21, MRC subsequently complements its movie-to-movie acquisition contracting strategy with an output distribution contract. This allows it to channel any movie for which it does not make (or is not able to make) a favorable acquisition contract through its output contract. The star talent safeguard against channel and distribution performance uncertainty is supplemented with a distribution contract safeguard. MRC thus ends up in a position similar to the Reliance case, with the exception that the distribution contracting is made by the investor and not the talent production company. MCR’s role very much resembles that of a production studio (see Figure 7.8), but is typically more limited to finance and distribution contracting that only allows the star talent production company (or jointly owned special purpose vehicles mainly controlled by the talent) to retain greater control over development and production transactions (Fleming, 2008d).

**Figure 7.8 - The contracting structure of the MRC case**
7.2.2 Contracting Star Talent: Investment, Distribution and Reputation Dependencies

With its ability to reduce uncertainty and thus encourage investments, star talent plays an important role in value creation. And since the amount of talent that at any time can claim “star talent” status will be limited, this also puts them in a favorable position for negotiating their share of value claiming. Reducing uncertainty for a movie by involving star talent therefore comes at a price. In some instances, the price has become prohibitively high.

“The Adventures of Tintin,” an animated movie released in 2011 and directed by Steven Spielberg and produced by Peter Jackson, faced difficulties receiving a greenlight due to the high fees required by these two stars. Universal, a major studio with a long working relationship to Steven Spielberg, turned the project down before it was eventually produced under horizontal co-production contracting between two other major studios, Sony and Paramount, which co-financed it. In 2006, Twentieth Century Fox, another major studio, decided not to greenlight a comedy starring Jim Carrey and Ben Stiller, two very popular comedy star actors, on the basis that their fees outweighed the odds of breaking even. And Paramount was reported to barely break even on the “Mission Impossible III” with an estimated production cost of USD 150 million, despite the movie earning a box office gross of nearly USD 400 million worldwide, which according to the reports was largely due to a gross corridor for its star Tom Cruise who ended up earning more than USD 80 million from the movie (Eller, 2008b).

For talent-controlled production companies like those discussed in the Reliance and MRC mini-cases above, contracting star talent is not an issue in the sense that the star controlling the company is already integrated. For other producers, however, the high compensation demanded by star talent may pose a significant challenge for the packaging transactions when trying to attach actors and director to a project. Tom, COO at a major studio, explains this particular problem from a distributor’s/financier’s perspective:

There are two words that mean nothing: “attached” and “committed.” It means nothing - because unless the talent sign... - they [producers] say “I have got Brad Pitt committed.” “Oh, so he must be in the movie?” “Well no, he has screenplay approval.” So all Brad Pitt has to do is say, “I don’t like this draft.” So they can’t come up with anybody. So, they can’t walk in the door and - they often say this –“I got Brad Pitt.” But of course they don’t have
authority to commit Brad Pitt 17.5 million dollars, so they don’t have Brad Pitt. The only way to have Brad Pitt is just to say, “We hereby commit to you, pay or play, which means that even if we don’t make the movie, you get paid, 17.5 million dollars - you are locked in as long as we have a commencement of principal photography by July 1st of next year.” Ok, we understand that, so therefore it’s a real commitment. Then it’s committed. And then we don’t use that word: We use “signed.”

Tom, COO, major studio

There is thus also a reverse relationship between production investments and star talent (Figure 7.9), and this relationship may be extended to include production-distribution contracting, which affects production investments (see Figure 7.5). For producers operating independently without an output contract or without some form of contracted access to production financing, it will be significantly more difficult to complete a package including star talent. When asked why they tend to obtain star-driven movies through output deals rather than acquisitions, Jennifer, marketing executive at a major studio specialty division, says:

*We don’t usually find those for acquisition. Most of the films up for acquisition tend to be the more artistic, low-budget ones. You know, things that people are able to put together themselves. We are able to attract more star power because we are part of a major studio.*

Jennifer, President Marketing, major studio specialty division

![Figure 7.9 - Relationships between contracting, production investments and star talent](image)

Michael, head of a production studio, also points to the relationship between production-distribution contracting, access to production financing and access to talent. However, his view is broader, seeing distribution contracting as one element of a producer’s reputation. When asked about the
benefits from having an output contract when carrying out packaging transactions, he says:

Michael: First of all, credibility. Agents believe that you’re capable of getting pictures made, and have the money to pay them, make them their commissions, ... They wanna put their emphasis on the people that have the money to do it. So, they look at the people running the company and say, “OK, that guy has been in business for 25 years, ran two studios or produced 47 movies, they know what they’re doing. That person has an office on the lot of Fox, they wouldn’t have an office there if they had no distribution deal with Fox [...]. They have international partners, and they have nine people working in their company. Clearly, it’s a real business.” The guy working across the street and says, “I’m gonna be in the movie business” and opens an office in Santa Monica and says, “I’m called The Movie Company,” nobody knows their name, and they don’t have a distributor, and nobody is working for him. The talent wouldn’t put their emphasis there - they wouldn’t believe him.

TG: So the better the studio [output] deal you have the higher up you are on the mailing list of agents...

Michael: You got it.

TG: OK

Michael: The appearance of power, proximity to power and perception of power.

Michael, Chairman and CEO, pact production studio

The importance of reputation is also expressed by George, an independent producer who previously worked under first-look contracting. He stresses his reputation when explaining how he obtains production investments for star-driven, high-budget movies for which he may start production without having a distributor contracted. When suggested that his approach sounds risky, he comments:

Yes, of course it’s risky. It’s very risky. This whole business is risky. But you know, our business is “people,” and ... I was lucky, so with people that are financing my movies I tell them: “I want to do this
movie and I know I’ll get the distribution for this movie.” And they know I’ll get distribution on this movie. The independent movies I made over the last few years, all of them were distributed by studios, all of them wide. Doesn’t mean I will not fail on my next movie, I might fail.

George, Producer/President, independent production company

So in George’s case his reputation, which one may in a relational contracting perspective (Carson, Madhok, & Wu, 2006) argue represents informal distribution access, replaces the distribution contract, which is the formalized distribution access, as a means to attract production investments. Thus, his access to star talent is through the relationships shown in Figure 7.10a below.

![Figure 7.10a - Relationships between reputation, production investments and star talent](image)

Following Michael’s argument above, it may be argued that reputation (and contracting) directly affects a producer’s access to start talent, which again attracts production investments as discussed in the previous section. The logical order of relationships between star talent and production investments may therefore also be switched, as illustrated in Figure 7.10b.

![Figure 7.10b - Relationships between reputation, star talent and production investments](image)

A producer’s reputation and having an output deal seem to be closely interlinked. First, output contracting directly enhances a producer’s reputation, as Michael is arguing above. Second, distributors will typically
only offer output contracts to producers who are already reputable. One producer who had just gotten his first first-look deal told Variety: “Basically, when you can get a deal, you don't need one” (Harris, 2005a), suggesting that he had achieved a reputation which would have allowed him access to star talent and investments even without an output deal. Other producers use the additional leverage provided by their first-look deal to attract and line up outside investors, making them less dependent on the studio distributor and possibly being able to turn their first-look contract into a co-production financing contract (Harris, 2001). Furthermore, the relationship between star talent and production investments is interdependent. The inclusion of star talent encourages production investments by reducing uncertainty (as discussed in Section 7.2.1), but to include star talent a producer will typically need to have access to production financing. The relationships identified here between contracting, reputation, star talent, uncertainty and production investments may thus be summed up as illustrated in Figure 7.11 below.

![Figure 7.11 - Relationships identified between contracting, reputation, star talent, uncertainty and production investments](image)

7.2.3 Contracting Attractive Literary Properties
Patterns similar to those identified for star talent above were also found for other core creative inputs vital to the packaging of a project, namely screenplays and/or literary properties. The attractiveness of literary properties may be similar to that of star talent in that the most popular properties will ultimately attract production investments (see Figure 7.6 above). Producer Michael Shamberg, who has worked under both output and acquisition contracting and produced several high profile movies, including
“Pulp Fiction”, “Garden State” and “LOL”, says to Variety that he would take five good scripts over a bucket of money any day because “you can always get the money if the material is good” (McNary & Garrett, 2007).

In his comments on the packaging benefits from having an output contract in the previous section, one of the interviewees, Michael, refers to agents generally, which covers talent agents representing star actors and directors, but it may also cover literary agents representing the work of writers. A relationship similar to that between contracting/reputation, production investments and star talent set out in Figures 7.9 and 7.10a above is for instance found in the following statement from a producer with an output deal at Paramount, a major studio, who says to Variety: "If you don't have [an output deal], people are going to think you don't have any juice. You won't get decent material from agents without a deal" (Harris, 2004). These are the same relationships, but with attractive literary properties or, more generally, attractive material substituting for star talent.

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**Box 7.3**

When asked if producers working under output contracting have any benefits over others when it comes to obtaining attractive scripts James, an independent producer who previously worked under output deals with a major studio, says:

> Yes, they do. Because obviously what [agents] are trying to do is to get them sold. And they know that the studio has an ongoing relationship with an individual, and therefore they have an investment in that guy that they’re trying to get back their money on. And so... the more things that that guy has that they want, they will be in a better place to get their money back on their investment in that piece of talent. So the agencies will always send those things to – they’ll say: “Who do we think can get this thing done at Warner Bros. that we have a relationship with?” Now, sometimes you know they are obviously in a weird spot because they represent... Let’s say CAA [a major talent agency] represented me and I was at Paramount. What do they do now? They’ve got Tom Cruise there and they’ve got me there, you know what I mean? If I’m smart I’m gonna go somewhere else, because I know CAA ain’t gonna send me the script first. It’s going to Tom Cruise’s company, because they have a lot more riding on their relationship with Tom Cruise than they do with me. So... but they will always send it to those guys first. And then what they’ll do with somebody who is not attached to the studio. They’ll say: “You know, we don’t have anyone strong at
In Box 7.3 above James, an independent producer, provides more detail for the argument that a producer’s access to attractive material is primarily dependent on its production-distribution contracting. According to James, agents will see producers operating under an output contract as more able to purchase the material. Due to the frequent use of option contracting for material acquisitions (see Section 5.3.1), the ability to acquire will typically equal the ability to produce a movie based on the property. To effectuate an acquisition thus requires substantial production investments, and operating under an output contract is seen as signaling access to the required production financing. As a result, the relationship very much resembles that between contracting, production investments and access to star talent illustrated in Figure 7.9 above. Furthermore, and implicitly referring to first-look contracts more than other forms of output contracts, James argues that agents will be aware that distributors have an added incentive to greenlight projects from first-look contracted producers, as this will be their only way to recoup the housekeeping payments they have invested in the producer relationships. Also, referring primarily to talent-controlled production companies in which the principal will typically be represented by a talent agency, James adds a producer’s talent agency affiliation as a moderating factor. If two producers represented by the same agency have an output contract with the same distributor, the more reputable of these two will always receive attractive material first, so the other would therefore be better off contracting with another distributor. Finally, according to James, only if an agency lacks a strong relationship with an output producer at a major studio distributor will they approach independent producers working under

James, Producer/President, independent production company
acquisition contracting with material. The objective will then be to have a movie produced based on the material under a pre-sale acquisition contract with a studio. And in these cases, the choice of producer will primarily rest on a producer’s reputation or perceived relationship with major studio distributors (similar to the effect of reputation argued by George in the previous section). Hence, producers working under acquisition contracting are generally second in line to those working under output contracting for attractive material.

It follows from James’ statement in Box 7.3 that agents representing attractive material are ultimately targeting the greenlight decision makers, and to create a bidding situation they try reach as many of these as possible at the same time (similar to that described by Jennifer in Section 6.2.1 for distribution rights bidding). For output distribution and some co-financing contracts, the producers will be the decision makers themselves, but for first-look and pre-sale acquisition contracts, producers are used as a link to and allies in selling the material to the distributors that will ultimately make the decision. Producers are also decision makers for movies made under non-presale acquisition contracting, but these are typically limited to lower budgets not considered sufficient or appropriate for the most attractive material. In sum, agents send their best material to the producers perceived most capable of effectuating an acquisition, and production-distribution contracting seems to be the primary determinant in the agents’ ranking of producers.

Generally, the same patterns as shown for star talent in Figure 7.11 above seem to also be replicated for attractive material and/or literary properties. The emphasis here has been on the relationships between contracting, production investments and access to attractive material, but the relationship from attractive material via reduced uncertainty to production investments is also evident in the data. For instance, when MGM, a studio distributor, and Relativity, a financing and production company, acquired the film rights to Robert Ludlum’s novel, “The Matarece Circle,” for three million dollars in 2008, it was seen as a reduced risk approach to creating a new movie franchise rivaling the highly successful Bourne-movies, which are also based on Ludlum’s work (Getlin, 2008). The material coming from the same author and within the same genre, as adapted for an already successful movie franchise, was thus seen as reducing product uncertainty and thereby as
attractive for the relatively high investments required to launch a rivaling franchise.

The strength of the relationships shown in Figure 7.11 may of course vary from case to case depending on the particular material (or talent) in question. As discussed previously, a small number of top talent is perceived as being able to significantly reduce product and distribution performance risk while others will have less impact (see Section 5.3.2). Similarly, the most popular material (e.g. film rights to some best selling books, a spec script from a popular and successful screenwriter or film rights to comic book characters) may also be seen as to significantly reducing uncertainty (see Section 5.3.1). Other talent and material will have less impact on uncertainty, but then on the other hand also require less from producers in terms of contracting, reputation and access to production financing.

7.2.4 Moderating Effects from Contract Uncertainty

The producer’s contractual or non-contractual relationship with distributors and sources of production financing, which for some contract forms are the same, is primarily what Michael is referring to when he sums up the packaging benefits flowing from output contracting with “the appearance of power, proximity to power and perception of power” in Section 7.2.2 above. It follows, then, that a producer’s ability to attract star talent and material will also depend on the perceived “power” of the distributor with which it has a relationship, and particularly so for first-look contracts, in which the greenlight decision rests solely with the distributor. The impact of this dependency is evident when a distributor’s perceived ability to greenlight projects is rapidly changing. In the mini-case described in Box 7.4 below, the distributor’s ability to greenlight is seen as deteriorating, thus significantly reducing the value of the first-look contracts for producers in terms of getting agents’ attention for attractive inputs. While they retain their contractual benefits and housekeeping payments, these producers are reduced to “lame ducks” for the remainder of their contract period. In the context of each of these output contracts, the distributor’s diminished ability to greenlight projects may have been ex ante unforeseeable, at least for the producer and possibly for both parties. It may therefore be described as a negative outcome of environmental uncertainty (the distributor’s position deteriorated beyond its control) and/or behavioral uncertainty (the distributor failed to disclose its true position). Safeguards will typically be included in output contracts protecting producer’s continued rights to housekeeping
payments and other benefits in case of disturbances on the distributor’s end (Harris, 2005a), but since this type of uncertainty still will negatively affect the contract’s effect on the producer’s ability to attract star talent and material, it may be seen as a moderating variable in the relationship between contracting, production investments and the ability to attract star talent/material, as indicated in Figure 7.12 below. To distinguish this type of uncertainty, which is directly related to the production-distribution contract from the project-related types it is labeled “contract uncertainty”.

**Box 7.4**

When Sony Pictures, a major studio, acquired MGM, another major but struggling studio, it created uncertainty among the producers that had output contracts with MGM as to Sony’s intentions and the future status of these contracts. Variety reports (Harris, 2005a):

[…] Some producers say they've been told not to worry about violating their first-looks and that they can take their projects anywhere without fear that MGM will cut off the electricity over contract violations.

However, an MGM rep said the studio will honor all obligations to its production companies -- and producers are obligated to submit their projects to the studio, per their contracts. […]

While MGM is keeping producers off the streets, it's also negated the core reasons a producer might want a deal in the first place: Someone to call and the backing that gives people a reason to take their calls.

Many producers say their deals are less about the money than the ability to call an agent or executive and identify yourself as being part of a larger and more powerful entity.

"It's more of an emotional thing." says a producer based at Warner Bros. "There's prestige in being on the lot. It's nice to be able to call an agent and say, 'It's (producer's name) at Warner Bros.'"
Another example of contract uncertainty is provided by James, an independent producer, in Box 7.5 above in which he describes the negative effect of management changes at a distributor for producers contracted with output deals under the outgoing management. Again, this is primarily relevant for first-look contracts (or pre-sale acquisition contracts if the producer-distributor relationship is not contractual) because these are the contracts under which producers are most dependent on distributors for greenlighting. While James does not extend his argument to attracting star talent or material, he clearly explains how a producer’s ability to get a project greenlighted may be negatively affected by a management change, and it is reasonable to assume that agents will anticipate such negative effects, recognize the producers’ new “lame duck” status and thus allocate a lower priority to the affected producers. In James’ example, the disturbance on the distributor’s end is clearly within the distributor’s control and the uncertainty is therefore best described as behavioral contract uncertainty.

**Box 7.5**

James, an independent producer who previously worked under output deals with a major studio, comments on how potential management changes at a studio distributor add uncertainty to an output contract, using the departure of Bill Mechanic as chairman at Fox Filmed Entertainment, a major studio, as an example:

*Inevitably, you have to recognize that relationships change and studio heads*
7.3 Coordination of Production and Distribution Transactions

Coordinated activities between producer and distributor are sometimes required for either party to carry out certain transactions, and a lack of coordination seems to deter specific investments into these transactions. The transactions particularly standing out with clear coordination needs in the data are packaging transactions (hiring star talent) on the producer’s end and exploitation transactions on the distributor’s end. These are among the producer and distributor’s more complex transactions and they are discussed in sequence here, with an emphasis on relationships between coordination on the one hand and contracting and investments on the other.
7.3.1 Producer’s Coordination Needs

In Section 7.2.2 above, Tom explains how most producers will not be able to hire star talent without the financial backing of a major studio distributor to cover their high fees. Such backing is obtained through contracting, most typically through output contracts, but also through pre-sale acquisition contracts. Since hiring star talent to a large degree is a question of attracting the necessary production investments, one may say that more integrated contracting facilitates the necessary coordination to allow for investments in star talent.

Furthermore, hiring star talent requires coordination between producer and distributor to facilitate offers of so-called gross deals. These are agreements between producer and talent in which the talent’s compensation is defined as a share of the distributor’s gross receipts from the movie (i.e. a gross corridor is defined and allocated to the talent), and it typically also includes an upfront advance payment drawn against this share. For the most popular stars, the gross corridor may often be as wide as 25%, and the most favorable deals have reached 35% (Dunkley & Brodesser, 2002), and the upfront payment or advance may reach more than USD 20 million (see Section 5.3.2 above). For commercially successful movies, the talent’s backend from a gross deal will typically greatly exceed the advance payment, as illustrated in the “Mission Impossible III”/Tom Cruise-example in Section 7.2.2 above. Technically a producer may of course grant a star 25% of distributor’s gross before contracting a distributor, but it would entail some serious complications.

First, a producer granting this type of gross deal to talent prior to contracting a distributor would face an uphill battle when turning around to negotiate with distributors since the gross deal has significant implications on the distributor’s own break-even point. A hypothetical example based on a simple standard industry estimate technique (Blume, 2006) illustrates the problem: Assuming a typical waterfall recoupment order as illustrated in Figure 6.3, and that a distributor would need to make distribution investments of USD 25 million in the movie (which is approximately the 2007-average for studio-affiliated specialty distributors), the distributor’s gross would need to reach USD 33.3 million for the distributor to make a cash break-even, and USD 41.7 million to break even if a 15% distribution fee should be calculated. If the movie for instance should end up grossing USD 30 million, the distributor would be left with a cash loss of USD 2.5
million (i.e. also without any distribution fee, interest or other imputed costs covered), while the star actor would walk away with USD 7.5 million. The complete production investment would also be lost. Since talent gross deals have such impact on their investment risk distributors would see any gross deals attached to a project as a significant liability. Considering that producers at the outset face a relatively small number bargaining when contracting a distributor, adding this type of liability would significantly increase its channel uncertainty, even though having the star would have an opposite effect.

Second, without a distribution contract it would be impossible for the producer to provide a precise definition of “distributor’s gross”. As discussed in Section 6.2.2 above, there may be significant variations in how this term is defined with important value sharing implications. Hence, star actors and their agents are likely to view any gross deal offer for a movie without distribution contracted as highly uncertain and thus less valuable.

More typically, when packaging a movie without a distributor contracted, a producer may offer talent participation in the producer’s gross receipts, i.e. the monies received by the producer from distributors. Such offer requires no coordination with distributors. Producers utilizing these types of talent contracts, however, will often seek revenue sharing distribution agreements in which the producer’s participation starts pari passu with the distributor’s recoupment of its distribution investments, as reported in Box 6.7. For the talent, participating in the producer’s gross is of course much less attractive than participating in the distributor’s gross, partly because the all-important producer-distributor split remains unknown; thus, such offers are not necessarily sufficient to attract star talent.

When asked why most commercial movies seem to be made with distributors attached prior to production, Michael, the head of a production studio and former chairman of a major studio distributor, names talent gross deals as one of the factors that demand integrated contracting for a project:

*Because they are expensive. Expensive big stars - gross participants. All those reasons drive it to be part of the studio process. You might make a six-million-dollar film and be sure of a million dollars [in foreign revenues] and hopefully get an acquisition of it in the post-*
production phase. You won’t make a sixty-million-dollar film and do that unless you’re a boob [an idiot].

Michael, Chairman and CEO, pact production studio

Michael’s comment is echoing Brad’s comment in Section 7.1.4 above on the significance of budget, and budget may also here be seen as a moderating variable. Star talent gross deals are typically associated with higher budgeted movies. Lower budgeted movies are less dependent on star talent, thus also on gross deals, and the need for coordination is therefore less.

7.3.2 Distributor’s Coordination Needs

Turning to the distributor’s needs for coordination between its distribution transactions and the production transactions, the data suggests coordination issues in a number of areas. Possibly most striking is the coordination needs for exploitation transactions, in which a key issue is the long lead time required by the distributor’s partners. For merchandising types of exploitation transactions, Ovadia (2006) suggests a lead time of one to two years prior to a movie’s release, the longest time typically required by video game licensees in order to have the games ready concurrently with the movie’s release. But also toys may sometimes require up to two years. For the “Spider-Man” example provided in Box 5.8, an announcement was made to prospective licensees two years before the movie was released, and it is evident from the text why so much time was needed (e.g. processing 10,000 approvals). If brand placements are included in a distributor’s exploitation transaction mix, these must be made prior to production so that the brands and products can be incorporated into the movie. And promotional tie-in types (see Box 5.9) also require significant lead time as explained by Emilie, marketing executive at a major studio, below. When asked about how she works differently with movies obtained through acquisition and output deals, she says:

When it’s an acquisition, usually the movie is made. We haven’t had anything to do with the early set-up of the movie, any early awareness, what have you. If it’s a movie that we made then I am usually involved from the minute we make the decision to make it, so I’m working on this year’s movies right now, next year’s movies, one movie for the following year… long-term planning. You know, it affects areas like third-party partners, McDonalds and Coca-Cola.
They plan way far ahead and dictate their advertising campaigns way far ahead and allocate their dollars. The acquisition movies, they’re done. So usually you get it a couple months before you throw a campaign together.

Emilie, President Domestic Marketing, major studio

With these demands for long-term planning many exploitation transactions will be impossible to combine with non-preservation acquisition contracting. Since not even the most basic form of coordination – the producer and distributor agreeing on doing the movie together – is possible, these movies will thus not be able to benefit from the extra distribution investments and value creation that these exploitation transactions could have brought (e.g. media buys).

While the exploitation transactions offer a striking example of coordination requirements, the distributor’s need for coordination with production transactions is much broader. For movies made under output deals, which Emilie refers to as “the movies we make,” she as head of marketing is involved from the moment the greenlight decision is made. When asked why this is important and what kind of inputs she provides she says:

I will weight in on casting decisions, you know. “Is it better if you had so and so and so and so and so. Or would you rather have a big star or an unknown? If I got you this could you take that?” That kind of thing... so sometimes casting decisions. Sometimes rating issues: “PG or PG13? We could shoot it a little bit this way or a little bit that way. Do you think it really affects the marketing of the movie?” So those are the initial conversations and then beyond that when the movie is in production you can do a lot of marketing. You can get a lot of stuff done while they’re shooting a movie and hold on to it for later. And not have to run around trying to find everybody... actors go to another project. So if you make a film and then you go to release it... you really should have enough photos of Mel Gibson and he is in, you know... God knows where, shooting another movie. You got to sort of track him down and his folks done this and maybe he has his hair differently, you got to do a shoot, you have to find a wig. So if you’re involved in the shooting, you can do special photo shoots. You can have your blinds if it’s an R-rated movie. You can
clean up some dialogs [for trailers]; you can shoot all your magazines covers for your publicity campaign. It’s just accessibility.

Emilie, President Domestic Marketing, major studio

Jennifer, who is a marketing executive at a major studio specialty division in which a much higher ratio of their movies are acquisitions, points out many of the same issues, but from a different angle:

When you acquire a movie, you often have, almost always have really bad [still] photography because no one’s had money to go and do photography during the shoot… still photography usually stinks. And for our kind of movie that’s really bad, because you are trying to get a New York Times Sunday pre-opening piece or an LA Times piece and you want a big photo of it and the photography is often just horrible. So we have to go back and try to get the cast back and get them back in costume or something and re-shoot something. And also EPK material, Electronic Press Kit, usually hasn’t been done so there are no interviews with anybody. Or they have been really badly shot so we often have to go back and try to re-create those materials. There’s obviously been no press on the set in most cases so… For one of our [output] productions we would bring press on to do the production pieces. You lose that opportunity. And, you know, also you loose any opportunity to help shape the movie. You can’t say: “This piece of casting is not so good” and “What if you did this” and... In our own productions, we have a lot to say and we have a lot of voting: “Is this person more marketable than that person? Who is better for publicity? Who will actually get out and work [for publicity] on the film and who won’t?” And when something is acquired all those things are done and you have nothing to say about it.

Jennifer, President Marketing, major studio specialty division

The contracting forms that allow producer and distributor to collaborate already from the packaging stage of development will thus not only provide distributors with all the lead time needed, but also allow them to provide feedback to producers that may better coordinate production transactions with distributors’ marketing strategies. This feedback may be in the form of approvals (for presale acquisition, first-look and some co-production
financing contracts) or consultation (for output distribution and some co-production financing contracts). Above, both Emilie and Jennifer emphasize casting. Through casting, the distributor may seek to ensure that a movie’s marketability matches the scope of its production and the revenues required for break-even. Casting may also affect the efficiency of their publicity transactions because some actors are more willing and positive to publicity work than others. Emilie also emphasizes rating, which is primarily a question of coordinating the producer’s and distributor’s thinking on target audience, which also will affect which marketing tools are available for the distributor. For example, a movie that from its general theme is suitable for a broad family-oriented audience will be difficult for the distributor to market if elements of the production (certain language or scenes) bump it up to a higher rating, thereby excluding the youngest audience and signaling to parents that it may be unsuitable as a family movie. For both these areas, the distributor may utilize market research tools that are seldom used by producers (see Section 5.4.2, other transactions). Also, according to Jennifer, without coordination some transactions are carried out so poorly that they have to be re-done, which is poor production economics, and some will simply not be done (e.g. publicity during production) and potential value creation may therefore be lost in the same way as discussed for exploitation transactions above.

Nevertheless, that potential value creation may be lost does not mean that it always is lost. Even when contracted prior to production, the distributor may choose not to utilize some marketing tool if they feel there is a negative tradeoff between these and certain aspects of value creation in production. However, these tradeoffs can only be evaluated by distributors if they are contracted prior to production. Julia, marketing executive at a mini-major distributor, provides an example in a relatively low-budgeted arthouse movie they distributed:

“[Movie Title]” which is a picture that in the “inde” world has done extremely well - it was very well received from an Academy perspective [for Oscar nominations]. That’s a picture that we were involved in production on and I think the campaign... We were involved as a marketing group very little during the production phase of that campaign. There was no on-set publicity; there was no on-set promotion. The decision was made not to do that because of the performance the director was required to get out of those actors.
It would just not work to have, you know, PepsiCola on Saturday, Entertainment Tonight on Sunday. It would have been counter-intuitive to what he was trying to get out of them. So we picked the campaign up after the picture effectively was finished. In my opinion, that picture would not have benefited from us being there on set and working that out at an early stage.

Julia, Executive VP Worldwide Marketing, mini-major distributor

7.3.3 Coordination Efficiency

The marketing executives interviewed also made comments suggesting that the coordination between producer and distributor tends to be most effective for producers with whom they have built a relationship through repeated transactions. When talking about how her studio specialty division sometimes likes to continue working with certain filmmakers that eventually “graduate” to make movies for the parent studio, Jennifer ads:

Yeah, and that makes my job much easier because it’s... When you are first getting to know the people, there’s this whole thing about teaching them the process, how we do it, how they wanna do it, how to collaborate. And once you have it done one time, it’s much easier to do it next time because you don’t have to... It’s like dating, you don’t have to go through that first date, you just get right to the point.

Jennifer, President Marketing, major studio specialty division

Similarly, when asked if the relationships built with her studio’s output producers affect her collaboration with these compared to producers from which the studio have made an acquisition, Emilie replies:

Oh absolutely. But also because there’s a short hand, that comes with it... Certain producers that I’ve worked with repeatedly - they trust us. They know we do a good job and there’s a short hand that goes with doing business with them that makes my life easier. And I’m sure it makes their life easier. When you’re starting from scratch, you have to get to a point, you know... Filmmakers and producers, generally, don’t trust studio people. I mean, they just don’t. You probably heard that from people. They just think that we have no talent and we are not creative and we only see the bottom
line and we won’t protect their art, and... generally speaking. So, the people that I’ve already convinced we are good guys and “we are gonna take care of you, and we believe in you and your movie,” that’s a good place to start. But the other ones, they come and they merely think that you’re gonna give them not enough attention. So clearly it’s easier to have a relationship.

Emilie, President Domestic Marketing, major studio

Because the coordination generally seems to become more effective with repeated transactions between producer and distributor, there may also be a coordination benefit to output contracting over pre-sale acquisition contracting. While the latter may allow collaboration already at the packaging stage, the collaboration may be less effective than under output contracts.

7.3.4 Coordination-Centered Relationships between Contracting and Investments

The coordination-centered relationships identified in the data throughout the subsections above are summarized in Figure 7.13 below. Generally, more integrated contracting forms allow for better coordination between production and distribution transactions within a project, and better coordination allows for greater specific investments in both production and distribution elements. The transactions with the most striking coordination needs, packaging star talent and exploitation, in which investments most greatly benefit from improved coordination, are both complex transactions typically associated with higher budgeted movies. The impact on the investments of producer and distributor not being able to coordinate these will therefore likely be less for lower budgeted movies. As discussed above, higher budgets generally entail more complex production and distribution transactions, and the importance of coordination and its impact on investments is thus increasing with budget and complexity.
7.4 Horizontal Contracting Effects on Investments

The horizontal contracting structure applied to a project may affect project-specific investments in both production and distribution transactions. Two patterns are identified in the data. First, all rights contracting seems to encourage distribution investments, and second, when split rights contracting is used, more vertically integrated forms of domestic distribution contracting seem to encourage production investments.

7.4.1 Effects on Distribution Investments

A movie’s performance in ancillary markets will generally depend on its primary market performance (see Section 5.4.1 above), and the data indicates that foreign territories are most often seen as ancillary markets. Hence, there is an expected spillover effect from a movie’s domestic market performance to its performance in foreign territories, and distributors making domestic distribution investments will thus seek to also control foreign territories to fully benefit from their domestic investments.

In Section 6.2.1 above, George, an independent producer, explains how a domestic distributor based on this logic almost forces him to buy back certain foreign territories he has presold as a condition for taking domestic rights. The distributor is hesitant to make the required domestic distribution investments unless it can also harvest the expected foreign externalities from these investments. George adds that his general experience is that
distributors will ask for foreign territories before making a commitment to invest in domestic distribution.

James, another independent producer who previously worked under output deals with a major studio, argues that the horizontal contracting will also affect how aggressively a distributor pushes a movie in the primary market:

There’s just no way in the world, having been through as many [movies] as I’ve been through, that anybody’s going to convince me that a domestic distributor that doesn’t have the overseas rights to the movie is going to take the domestic release... and go out as aggressively as they would if they had the rest of the world. It’s just not gonna happen. Cause every dollar here has a spillover effect overseas. Everybody over there knows what’s going on over here, what’s a hit, what’s not, you know, they know when movies are coming out, they’ve seen the television, they’ve seen the premiere. Every dollar you spend here does have a ripple effect. It’s not dollar for dollar, but it has a ripple effect. And that’s something that as a producer you are well aware of, but, like I said, if they’re not the same group they’re not going to treat it the same way.

James, Producer/President, independent production company

When asked about preferences for all rights or split rights acquisitions, Jennifer, marketing executive at a major studio specialty division, reiterates the same view with added detail and reasoning from the distributor’s perspective:

Jennifer: We would prefer to have worldwide rights, or English-speaking rights. We have a lot of pay-television deals through [the parent studio]. So we have good deals in Germany, in France, in Italy, in Spain where we get money through pay-TV. And if we have to make a North America-only deal we forego all that. So it’s really hard for us to come out on a North American deal, it’s very risky. We don’t have any cushion, we don’t have any way to say: “But even if we totally fail we’re gonna get this amount of money from Germany, this amount of money from France” - you know, it doesn’t exist. So it’s kind of like doing a tightrope without a safety net. And we did it with “[Movie Title, same as in Box 6.1].” “[Movie Title]” was essentially a North America-only deal, I mean we had one or
two other territories, and we came out great because the movie did really well and it got great reviews, but we don’t like to do the high-wire act too many times. We’d much rather have worldwide rights, or at least give us couple of territories where we can get some form of television money.

TG: OK, so you see it as more of a high-wire act... How does it affect then the way you think about it marketing wise if you have a movie that you know you only got North American rights on... or if you have worldwide?

Jennifer: Well, I can be more aggressive if we have worldwide rights. I can be more aggressive about spending in the US to get it going. Cause I know that if we can get something going here, it’s gonna go all over the world and every dollar I’m spending here is gonna help the future. And also I have this safety net of foreign money coming in from TV, so even if I screw up, I’m gonna be ultimately saved. But if it’s North America you have to be really cautious, because you could just throw yourself into a big loss and you are not even helping [your company for] the rest of the world, you’re not helping [your] International Home Video [division]. You’re helping other people on the movie rather than helping yourself.

Jennifer, President Marketing, major studio specialty division

Jennifer’s last sentence seems to reflect the thinking of George’s distributor too; if he cannot buy back the pre-sold territories for them, they will be helping other people rather than helping themselves. Jennifer’s comments also show that the wish to control all rights is not only a question of being able to exploit the upside from cross-territorial externalities, but possibly more so a question of protecting the downside. The distributor is reducing its investment risk by adding a “cushion” of foreign output licensing deals, primarily for pay-TV (of the type also described by Tom, COO at a major studio, in Box 6.12). These licensees will typically pay a fixed price for each movie supplied by the distributor that has received a theatrical North American release. These revenues are thus not dependent on audience reception, and as such these deals provide a “safety net” of predictable income for the distributor.
It follows from the above that in these cases referred to by the interviewees, more horizontally integrated contracting has a positive effect on distribution investments. First, split rights may deter distribution investments since it may increase the distributor’s exhibition channel uncertainty by excluding ancillary output licensing deals. Second, all rights contracting may invite the distributor to more aggressively invest in primary market distribution since it will be able to also benefit from ancillary market spillover effects. The relationships are illustrated in Figure 7.14 below.

Figure 7.14 - Relationships identified between horizontal contracting, uncertainty, spillovers and distribution investments

Similar relationships may also be present in horizontal co-production contracting. Emilie, marketing executive at a major studio, suggests that the majority of these contracts are made as so-called one-pot deals, meaning that studios co-financing and co-distributing a movie split all revenues rather than each retaining their own revenue streams (see Box 6.3). Based on the above, one may argue that this is done to align investment incentives and to avoid free rider behavior from the distributor holding foreign rights.

7.4.2 Effects on Production Investments

The degree of horizontal integration also affects production investments, even though these patterns are somewhat sketchier than for distribution investments. However, two patterns were found. First, split rights contracting may pose a coordination problem between the producer and the various distributors that deter investments. Second, under split rights contracting, foreign distributors’ production investments are dependent on the domestic distribution contracting.
Split rights contracting affects the relationship between distributors and producers, and James, an independent producer, links the production investment argument to how this type of agreement typically reduces the distributors’ control and influence. When asked if split rights means greater control for the producer, he replies:

Yeah, absolutely. It does. But it only puts him in a stronger position because you have less people..., well, more people with lesser risk, essentially. That’s what I think sort of empowers the producer in that place. You have less money at risk from any individual guy so no one guy can come up and say: “Yeah, well, it’s our 100 million dollars so I don’t care what you say,” you know, “blah, blah, blah.” It’s like “this is our 28,” and this guy’s got 14, this guy’s got 9, and this guy… so you are in effect the pinnacle of a spoked wheel that sort of goes in those different directions and it’s all sort of feeding back to you… But, but you know, in effect I don’t see necessarily that kind of power being something that’s going to generate better movies. I think it’s just ..., unfortunately what it really means is that more people are indifferent about the result. You’re running something that nobody cares about, because nobody cares enough about it to fund it.

James, Producer/President, independent production company

From here, James makes a production investment argument similar to the distribution investment argument made by Jennifer above, in which she says than an extra investment primarily benefits other people on the movie, not yourself. James says:

It’s hard to convince somebody for example that this extra amount of money is really going to make [the movie] better if you’ve got a feeling like “We’ve only got 20% in it, what the hell do we care?”

James, Producer/President, independent production company

Under a split rights contract, no distributor is likely to hike its contribution towards the production investments (i.e. its acquisition price) without all other distributors matching this hike with amounts relative to their “share” of the movie (and what “share of a movie” any single territory represents is often not specified or agreed upon in the contracts). A distributor making a
unilateral extra production investment would be “helping other people on the movie” since production investments generate added value to a joint product, of which all distributors have a share. Seeking extra investments for production budget hikes from a group of split rights distributors will thus first pose a coordination problem. Second, split rights contracting is typically associated with vertical contracting types in which distributors have less control over production transactions (see Tables 6.1 and 6.2), so hesitating to invest any extra in production may not only be a question of “not caring,” but also of lacking safeguards to protect the investment. However, James’ argument is primarily a question of adaptation: New information may reveal that extra project-specific investments into production are desirable, but the lack of horizontally integrated contracting poses transaction (coordination) costs, preventing such investments and thus resulting in ex post maladaptation.

A stronger pattern for production investments is found in how, under split rights contracting, the vertical contracting form of the domestic contract affects the availability of production investments from foreign distributors.

When Michael, head of a production studio operating under a co-production financing contract, describes the financing of his company and thus the sources for his production investments in Box 6.18 above, he says that “each of the partners internationally provide us with an advance based upon the percentage of the budget that their territory is responsible for.” These partners are distributors in larger foreign territories such as Japan, the UK, Australia, Spain, Italy and France, with which his company has output deals. Some smaller territories are included in the contract with the domestic distributor, and the rest are sold under a contract with an international sales agency. As discussed in Section 6.3.2 above, the advances his company receives from these various output deals represent a substantial part of the production financing share Michael’s production studio covers under its co-production financing contract with the domestic distributor. However, these foreign output deals, and consequently a substantial share of the producer’s financing under the co-production financing contract, is dependent on that same contract. Michael explains:

*In the international market, all international distributors in order to make a deal make it a condition we’re having US distributors. If a product is American-international product, they want you to have a*
major North American distributor if they gonna guarantee the release internationally in their territory. Almost all of them require that. And then on a contrary side, if you don’t have a domestic distribution deal, you’ll have to go around and sell each picture to a studio for domestic distribution, which is possible to do. But it’s hard to run a business that way... - it’s not necessarily hard to make an individual picture that way - cause you can’t really forward plan too easily. If you know all your domestic distribution is covered by one company, it’s one less challenge you have to deal with on every picture.

Michael, Chairman and CEO, pact production studio

Here, one recognizes the “foreign territories as ancillary market”-thinking also from the foreign distributors’ perspective. The foreign distributors see a North American theatrical release as a guarantee for the movie having the required marketability and playability also in their territories and furthermore expect to benefit from an awareness created through the North American release plus possibly also from marketing materials created by the North American distributors (see Box 6.1 above). Without a North American theatrical release, contracted foreign distributors typically perceive the uncertainty as too great for guaranteeing a release and thus an advance from their own territory. Exceptions do occur (see Box 6.5), but then typically for movies that contain star talent or similar elements that can substitute for the North American distribution contract in terms of reducing uncertainty.

While some co-production financing contracts are not or less dependent on split rights (as for Dreamworks and Pandemonium discussed in Section 6.3.2 above), it is a reoccurring pattern in the data that they are of the split rights type and that producers rely on foreign output deals to cover their part of the production investments. When asked if an all rights deal with the domestic distributor would have made it difficult for him to cover production investments Michael, replies: “You wouldn’t have any financing resources. You wouldn’t have any. Zero.”

The relationships between split rights contracting, domestic vertical contracting and production investments are illustrated in Figure 7.15 below. The relationships are very similar to those shown between vertical contracting and production investments in Figure 7.5 above, but the model
below may be seen as a special case in which production investments come through foreign distribution contracts. The similarities are underlined by Ryan, marketing and distribution executive at a larger independent production company, who says that their foreign equity investors providing project-specific production finance are no different from the foreign distributors with regard to the requirement of having North American distribution contracted.

7.5 Summary of Empirical Relationships

A summary of the empirical relationships detected in the data and discussed in the previous sections is illustrated in Figure 7.16 below. It includes the key variables studied and identified, but to increase legibility it excludes some finer distinctions (e.g. between domestic and foreign contracting as in Figure 7.15 above and the role of commitments in Figure 7.5). Considering that it only reflects the patterns that clearly emerged from the data and yet draws a somewhat complex picture, it also serves as a reminder of the limitless detail and complexity of the empirical world.

While somewhat complex, it does provide an overview over which variables affect each other. It shows that the factors that directly affect project-specific production investments are channel and distribution performance uncertainty, as well as the degree of coordination between producer and distributor. Project-specific distribution investments are directly affected by the same two factors plus the production investments and externalities linked to horizontal distribution. Of these variables that directly affect investments, vertical contracting directly affects channel and distribution performance uncertainty as well as coordination. Similarly, horizontal contracting affects channel and distribution performance uncertainty plus externalities. There is thus a relatively direct relationship between contracting and project-specific investments through these intermediate variables.
The figure also clearly illustrates the centrality of channel and distribution performance uncertainty. Treated as one composed variable, as here, it affects both production and distribution investments, and is affected by both vertical and horizontal contracting. Furthermore, it affects and is affected by a number of other intermediate variables, thus playing a key role in how these affect investments and how they are affected by contracting. Borrowing one of James’ metaphors from above, one may say that channel and distribution performance uncertainty is the closest one gets to the pinnacle in the spoked wheel of contracting-investment relationships.

Figure 7.16 - Summary of empirical relationships (with effects from moderating variables marked by dashed arrows)

The centrality of star talent and material is reflected in how it affects channel and distribution performance uncertainty via product uncertainty, and thus
investments. Similarly, a project’s budget level, determining the degree of asset specificity for project-specific production investments, is central as it affects channel uncertainty, and it further affects the complexity that moderates the effect of coordination on both production and distribution investments. Reputation is important, as it affects access to star talent and material, vertical contracting and channel and performance uncertainty. And finally, contracting uncertainty needs to be considered since it moderates the effect of vertical contracting on channel and distribution performance uncertainty, and therefore also on investments.

The complexity is also mirrored in the length of certain relational chains and hence in the interplay between variables. For instance, vertical contracting affects reputation, which again affects access to star talent and material, which reduces product uncertainty and therefore channel uncertainty, which again encourages investments in both production and distribution (for which the first also affects the second). Along the way down this chain, there are other interactions between variables (e.g. reputation directly affects channel uncertainty), and variables outside the chain will also affect the outcome (e.g. producer-distributor coordination, which is dependent on vertical contracting, will directly affect investments).
8 Implications for Understanding the Origins of Specific Investments

This chapter will review the findings presented in the previous chapter from the perspective of the express research objective to better understand the effects of governance structure on specific investments. Broader implications for the proposed transaction value model and TCE theory are discussed in the next chapter.

First, a note on governance structure and specific investments: In the context of this study, governance structure equals contracting since all vertical cases represent contractual exchanges (integrated and spot market exchange cases are excluded or do not exist). Specific investments or asset specificity as identified in this study does not fit neatly into Williamson’s (1991) categories, but may best be categorized as product specificity, a category developed by David and Han (2004) to include such empirical measures of asset specificity such as customized final product, customized input component, and development cost of final product, which is also similar to Masten’s (1984) product or design complexity. Since Williamson emphasizes physical and human asset specificity, his focus is on how specific investments create production cost savings. In the context of this study and with the type of asset specificity examined here, looking for production cost savings following specific investments creates little meaning. However, production cost savings should not be seen as an end in itself, but as a mean of value creation, and product-type specific investments create value directly instead of indirectly via production cost savings. Williamson (1985) posts the following key tradeoff with regard to physical type specific investments: “Do the prospective cost savings afforded by the special purpose technology justify the strategic hazards that arise as a consequence of their nonsalvageable character?” (p. 54). In the context of product-type specific investments it may be reformulated as: Do the prospective added value afforded by specific investments justify the strategic hazards that arise as a consequence of their nonsalvageable character?

The following sections will discuss the theoretical implications of the relationships between contracting and specific investments presented in the

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6 Interestingly, this is the category of asset specificity measurements that has obtained the strongest support when testing asset specificity as an independent variable in the empirical TCE literature (David & Han 2004).
previous chapter. These relationships are related to both the vertical and horizontal dimensions of contracting (see Figure 3.3). Since no simple direct relationship was discovered, the discussion is organized around each of the intermediate and underlying variables identified: uncertainty, coordination and spillovers. Finally, in a more holistic view of the relationships identified between contracting and specific investments, the concept of interdependence as developed by Thompson (1967) for organizational design theory is discussed and adapted to the current TCE context.

8.1 How Contracting Affects Specific Investments due to Uncertainty

It has been the aim of this study to contribute to expanding TCE theory not necessarily by incorporating new concepts and constructs, but primarily by further developing the understanding of interplays between its already defined core constructs. It follows from the proposed transaction value model that specific investments are treated as the dependent variable and contracting is chosen as the focal independent variable; the study is thus turning one of the most important and tested tenets of TCE upside-down. This ensuing research strategy is also in line with suggestions made by the authors of two recent reviews of the empirical TCE literature (David & Han, 2004; Macher & Richman, 2008). As established in the previous chapter, it is particularly interesting in this context that when no clear direct casual relationship from contracting to specific investments is identified, the most prominent intermediate variable to emerge establishing such relationships is uncertainty, another core TCE construct.

This section will first discuss the effects of contracting on specific investments via uncertainty directly, and then also the indirect function of resources in this relationship.

8.1.1 Uncertainty as a Sole Intermediate Variable

As described in Chapter 2, the previously established TCE relationships between specific investments, uncertainty and contracting may be illustrated as in Figure 8.1 below. A certain level of uncertainty is assumed to always be present, and this causes disturbances to which the capacity of each type of contract to respond will differ (Williamson, 1985). The two key established relationships are (marked as arrows 1 and 2 in Figure 8.1):
As specific investments increase, the transaction costs associated with less integrated forms of contracting increase and more integrated forms become preferred over the less integrated forms (1).

For any fixed nontrivial level of specific investments, increased uncertainty raises the transaction costs associated with less integrated contracting forms, and more integrated forms become preferred over the less integrated forms (2).

Figure 8.1 - Established TCE relationships between specific investments, uncertainty and contracting form

While the first of these two relationships have received relatively strong support in the empirical literature, the empirical results for the second are less convincing (David & Han, 2004). However, as David and Han also point out in their review, this may partly be a result of misreading the theory, testing uncertainty as having a direct effect on contracting instead of a moderating effect as shown in Figure 8.1. It follows from (2) above, that at low levels of specificity any changes in uncertainty will have little or no effect on the preferred contracting form (Harrigan, 1986), and such results may be misread as a lack of support for the theory if the level of asset specificity is not properly taken into consideration.

Turning to the findings between these three variables described in the previous chapter, two further relationships may be added. First, in the cases studied here, uncertainty is dependent on the contracting form. More vertically integrated contracts provide the producer with more commitments and safeguards regarding the distributor’s share of the joint value creation, thereby reducing channel and distribution performance uncertainty. By
adding product uncertainty, it has the opposite effect on the distributor. The increased level of uncertainty for the distributor may be moderated by assigning more control over production transactions to the distributor, but this is a zero-sum game, as it reduces the producer’s control. More integrated forms of contracting therefore imply a tradeoff between less uncertainty for the specific upstream investments and more uncertainty for the specific downstream investments. Differences in uncertainty that follow from sequential decision-making are to some degree leveled out by more integrated contracting.

Also, more horizontally integrated contracts reduce market performance uncertainty. There are primarily two mechanisms causing this reduction in uncertainty: cross-collateralization and the exploitation of established downstream market channels, if any. With horizontally integrated contracts, the distributor may cross revenue streams from various territories and media and thus recoup losses in one channel with profits made in another. It also allows distributors to utilize established exhibition sector output contracts (e.g. pay-TV agreements) that will typically deliver a fixed pre-negotiated fee. The presence of both mechanisms reduces the uncertainty under which specific distribution investments are made. However, for revenue-sharing contracts, the distributor’s ability to cross revenue streams may be seen as increasing the producer’s market performance uncertainty since the producer’s share from profitable channels is less likely to be paid out. Distributors absorb their losses from revenues that would otherwise have been subject to a split with producers. Hence, the effects of this mechanism on uncertainty become a zero-sum game between the distributor and producer because revenue streams are essentially crossed when they reach the distributor instead of when they reach the producer. The overall uncertainty effect of more horizontally integrated contracting will thus largely depend on the distributor having established downstream market channels.

Second, in the cases studied here, reduced uncertainty allows for and encourages specific investments. This relationship requires somewhat more of a clarification since the interviewees would often emphasize risk rather than uncertainty. They stressed the risk associated with making substantial specific investments, and that this risk under certain circumstances will be too high and thus deter investments, a pattern that is also reflected in the secondary data. In the TCE literature, Chiles and McMackin (1996)
distinguish between risk and uncertainty by defining risk as “the subjective possibility of loss as perceived by the decision maker” (p. 80), which is different from uncertainty that does not feature any perceived probability or loss. A useful clarification of the relationship between the two concepts is provided by Yates and Stone (1992), who define the critical elements of the risk construct as: (a) potential losses, (b) the significance of those losses, and (c) the uncertainty of those losses. They argue that higher uncertainty increases the probability of a loss or the loss likelihood. The overall risk they describe as an essentially multiplicative relationship between loss likelihood and the loss significance. The latter is a function of the specific loss and the subjective significance attributed to that loss (e.g. the decision maker’s risk preferences). For any specific decision maker (e.g. a production investor), the overall risk of any specific loss (e.g. the complete loss of the production investment) will therefore be a function of uncertainty since the level of uncertainty will determine the likelihood of the loss.

The findings presented in the previous chapter show that high channel uncertainty discourages specific production investments, and that high product uncertainty discourages both distribution commitments (thus increasing producer’s channel uncertainty) and specific distribution investments. While there has been a lack of attention to specific investments as a dependent variable in the empirical TCE literature, these findings are in line with empirical findings in the broader economic literature. Among the most interesting studies is one by Guiso and Parigi (1999), which investigates the effect of uncertainty on the investment decisions in a sample of Italian manufacturing firms. Their micro data allow them to identify shocks to specific firms that are easily lost in the aggregate data more commonly used in the economics literature, and they do find a negative relationship between investment and uncertainty. Other things being equal, they find that firms with a higher perceived uncertainty are less responsive to increases in expected future demand and invest less. A review of the empirical economic literature on the effect of uncertainty on investment decisions shows the same results (Carruth, Dickerson, & Henley, 2000). Furthermore, and most interesting in the context of this study, Guiso and Parigi find uncertainty to have a substantially stronger negative influence on the investment choices of firms that cannot easily dispose of excess capital.

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7 Risk neutrality is a default behavioral assumption in TCE (Williamson 1985), but extensions for risk aversion and risk seeking have been made (Chiles & McMackin 1996).
equipment in secondhand markets. Writing outside the TCE paradigm, Guiso and Parigi do not refer to asset specificity, but rather to the degree of the *irreversibility* of investment decisions. As an example of complete irreversibility, they describe machines that are designed to be used only in a specific firm and accordingly cannot be converted to alternative uses even within the firm’s industry, which clearly would be defined as asset specificity within a TCE perspective. A recent study that further investigates the negative effect of uncertainty on irreversible investment decisions also finds that the negative effect increases with the degree of irreversibility (Belanova, 2012), which may imply that the negative effect of uncertainty on specific investments increases with the degree of specificity.

In the previous chapters, we have seen that investment decision makers try to avoid making investment commitments under high uncertainty because: a) investments are considered as sunk costs (irreversible) due to the project specificity, and b) there is a real possibility of losing the complete investment or at least a significant share of it if the movie does not turn out as expected and/or fails in attracting a sufficiently large audience (see e.g. Ryan’s “Theodore Rex” example). The potential losses are therefore substantial, and particularly so for higher-budget projects. Hence, unless a decision maker has a particularly strong risk seeking attitude, the loss significance is high, which makes the overall risk very sensitive to the level of uncertainty.

It follows that deciding to make a specific investment under a certain level of uncertainty entails a transaction cost in the form of an opportunity cost, since it precludes the option of making the investment under lower uncertainty and hence with a lower overall risk (e.g. in the future when more is known). The higher the uncertainty, the higher the overall risk and thus the higher transaction cost.

The two additional relationships identified for the cases studied here may be added as propositions to the established relationships between contracting, uncertainty and specific investments (as indicated in Figure 8.2 below):

(8.1) *More integrated contracting balances out uncertainty between the transactors’ respective specific investments and becomes preferred over less integrated forms when seeking to reduce uncertainty for particular specific investments.*
As uncertainty decreases for a particular specific investment, the transaction costs associated with that specific investment decreases, thereby encouraging a higher specific investment to be made.

Figure 8.2 - TCE relationships between specific investments, uncertainty and contracting form identified in this study (established relationships marked with dashed arrows)

The causal logic and interplay between these two relationships may be further illustrated by looking at two scenarios drawn from the data presented in the previous chapters: The production-distribution contracting for a high-budget and low-budget theatrical movie. The high-budget movie will require large specific upstream investments (production investments). The loss significance will be high because: a) the amount invested is substantial, and b) the degree of specificity is higher since only a few distributors will be able to provide the required width of distribution. This specificity is added to that which follows from the investment’s project specificity. The investment is therefore highly sensitive to the loss likelihood determined by the level of uncertainty. Under more integrated contracting, distribution commitments are made at the time of the investment decision, thereby significantly reducing channel and distribution performance uncertainty. This may sufficiently reduce the overall production investment risk to a tolerable level, thus allowing these specific investments to be made. On the other hand, the low-budget movie will only require more modest specific upstream investments (production investments). The loss significance will be lower because: a) the amount invested is lower, and b) the degree of specificity is lower since more distributors are available to offer a narrower release still sufficient to recoup the production investments (and a significant share of the investment may also be recouped in ancillary markets alone should the
movie fail to obtain a theatrical release). This investment is less sensitive to the loss likelihood and to channel and distribution performance uncertainty. Less integrated contracting may thus be preferred for lower budgeted movies. Additionally, substantial specific distribution investments may be made for movies with low production budgets if they turn out well (see e.g. the “Blair Witch” mini-case discussed in Section 5.4.2). An uncertainty tradeoff provided by more integrated contracting would clearly not be desirable. Adding product uncertainty to a sizeable specific distribution investment would significantly increase its overall risk, while reducing channel and distribution uncertainty would have much less of an effect on the specific production investment’s overall risk due to its much smaller size.

In the previous chapters, distinctions have been made between the primarily empirically grounded types of uncertainty defined in Section 5.6 and throughout the following analyses, and it was shown in Chapter 7 that different types may have distinctly different functions in the relationships between contracting and specific investments. Based on these findings, one would expect two otherwise identical quantitative studies of the relationships shown in Figure 8.2 above, in which uncertainty is operationalized as channel uncertainty in one and as contract uncertainty in the other, to yield very different results. The latter would clearly be less likely to confirm the propositions made above. To avoid such discrepancies and improve reliability, a more precise linking of these empirically grounded types of uncertainty to theoretically developed categories within TCE would be desirable, but the TCE literature seems to offer only limited guidance.

As described and discussed in Sections 2.1 and 5.6 above, the distinction between environmental and behavioral uncertainty is useful for separating uncertain external circumstances relevant to a transaction from an uncertain performance by the transactors. However, these categories’ value here is limited, as it may be unclear whether a specific type of uncertainty belongs in one, the other or neither of these. Is for instance product uncertainty environmental or behavioral? An argument may be made for it being environmental, as it is an inherent quality of creative goods such as movies that their value cannot be accurately assessed until they are released to consumers (Caves, 2000). On the other hand an argument may be made for it being behavioral since the quality of a movie is a function of production activities and thus the behavior (which may be strategic) of a transactor.
Some may deem both arguments feeble and conclude it does not belong in either category, or that each category is too broad to convey useful information about its attributes. In the current context, the distinction made by Walker and Weber (1984) between volume uncertainty (the inability to accurately forecast the volume requirements in a relationship) and technological uncertainty (the inability to accurately forecast the technical requirements in a relationship) is not helpful either. Both are environmental uncertainties, and neither captures the differences between the empirically grounded categories.

Also, David and Han’s (2004) review reveals that the operationalization of uncertainty in empirical studies covers a wide range of measurements. In addition to behavioral, they create the primarily environmental categories of market conditions and technology, but these are less theoretically grounded than just the groupings of the operationalized measures used in the reviewed studies. And even with two new categories added, a number of their reviewed measures remain uncategorized.

One possible way forward may be to follow the lead of Carson et al. (2006) and more carefully distinguish between volatility and ambiguity as aspects of uncertainty. They define volatility as the rate and unpredictability of change in an environment over time, which creates uncertainty about future conditions. Since it is difficult to anticipate all possible future contingencies ex ante, ex post adjustments usually become necessary in a volatile environment, and as such volatility is a key facilitator of opportunistic behavior. Drawing on Ouchi (1980) and others, they define ambiguity as the degree of uncertainty inherent in perceptions of the environmental state, irrespective of its changes over time. Ambiguity is therefore less about an uncertain future as about uncertainty about present and past experiences.

While it is the volatility aspect of uncertainty that most often has been chosen for the operational measurements of uncertainty in the empirical TCE literature (Carson et al., 2006; David & Han, 2004), it is not difficult to recognize the ambiguity aspect in the uncertainty that engulfs the production-distribution contracting in the motion picture industry. This is particularly true if one relaxes the limitation of ambiguity as uncertain perceptions of the environmental state, but instead looks at it as uncertain perceptions in general. This is a more internally focused aspect of ambiguity adapted to capture the instrumental imperfection of production and
distribution technology (Thompson, 1967) discussed in Section 5.6. Performance uncertainty, which is also a key driver of channel uncertainty, is to a large extent a result of different parties having different perceptions of a project’s key inputs (screenplay, talent, etc.) ex ante and eventually also of its ex post quality as a finished product (prior to release). A striking example of the latter is the mini-case of the “Happy, Texas” acquisition discussed in Section 6.2.1 above, in which uncertainty in distributors’ perception of the completed movie resulted in a gross over-valuation. In highly ambiguous environments like these, opportunistic behavior will sometimes go undetected, while at other times accusations of opportunism may be made where there are none (Carson et al., 2006). While quite general, the following statement from James, an independent producer, captures this aspect of the uncertainty:

> There’s always this marketing - production problem where, you know, marketing people always think that the production people make lousy movies and they can’t sell them, and the production people sit there and think that they make great movies and these idiots in marketing don’t understand how to get an audience. It’s been going on from the beginning of time.

James, Producer/President, independent production company

The volatility aspect of uncertainty is much less prominent in this environment. There is volatility in terms of what types of movies and what stars are most popular among audiences at any given time, but only limited so within the life cycle of a movie project from initiation through theatrical release, which is the relevant timeframe in this study. One may argue that the demand for any particular movie is highly volatile (prior to release), but this is primarily a function of the ambiguity with regard to its qualities (product uncertainty as well as production and distribution performance uncertainty), and not a result of general demand changes in the market. On an aggregate level, movie demand among audiences is in fact remarkably stable when seasonal cyclical variations are accounted for (Vogel, 2010). Consumer prices in the theatrical (and some ancillary) markets are also standardized and thus relatively stable, and this stability continues into the distribution sector through standardized contracts and terms used with many exhibitors. While there are technological changes and advances (3D exhibition, video-on-demand, etc.), there is very little technological volatility within a
project’s life cycle. In general, it would be difficult to argue that the high level of uncertainty identified in this study and in previous studies of the motion picture industry is a result of volatility.

Since the production-distribution transactions studied here take place in a high-ambiguity-environment with relatively modest volatility, it may be more likely that the findings made here will be valid in other similar environments than in environments with a low ambiguity but high volatility. Both kinds are highly uncertain environments, but yet quite different in terms of the uncertainty’s nature.

It follows from the above, that using the term “uncertainty” in propositions (8.1) and (8.2) and in Figure 8.2 above may be too broad and thus reduce the validity of the propositions made. A narrower category of uncertainty is preferred. Hence, in relation to the lack of an uncertainty category established in the TCE literature that both captures the nature of the empirically derived categories used in previous chapters and reasonably precisely differentiates between these types of uncertainty and others, two steps are made in proposing a more theoretically grounded category with validity outside the context of this study. First, and simply, the term “ambiguity” is used instead of the broader “uncertainty” which also captures volatility. The second step is constructing a concept that unites the type of ambiguity found in product uncertainty, channel uncertainty and distribution performance uncertainty. Since the product (movie) is derived from activities in the production transactions, production performance uncertainty is also implied and included. Essentially, these empirical categories are united via the joint product concept discussed under value creation in Section 6.2.1 and elsewhere above. Looking at the cumulative output created by the production and distribution transactions for a particular movie (its image, see Table 1.1), and thus under the scope of the production-distribution contract, all these empirical uncertainty categories become related to the product, or more precisely, the joint product. Ambiguity about this joint product stems from ambiguity about the movie’s form (product uncertainty) about the quality and nature of the production and distribution performances (production and distribution performance uncertainty), and finally about its completeness (channel uncertainty). A joint product ambiguity category or type of uncertainty is therefore proposed to capture the ambiguity surrounding the joint product created in a transaction dyad.
Hence, the effect of contracting on specific investments via uncertainty may be more precisely stated and illustrated as follows:

(8.1) revised: More integrated contracting balances out the joint product ambiguity under which the transactors’ respective specific investments are made and become preferred over less integrated forms when seeking to reduce joint product ambiguity for particular specific investments.

(8.2) revised: As joint product ambiguity decreases for a particular specific investment, the transaction costs associated with that specific investment decreases, thereby encouraging a higher specific investment to be made.

Figure 8.3 - TCE relationships between specific investments, joint product ambiguity and contracting form identified in this study (established relationships marked with dashed arrows)

While the joint product ambiguity construct is significantly narrower and thus more precise than uncertainty, one should be careful not to consider it a “black box.” Micro analysis is likely to reveal dynamics within the construct similar to those identified in this study,8 which may be important for a thorough understanding and reliable operationalization.

8.1.2 Adding Resources to the Mix
In Section 7.2 above, it is shown that star talent and attractive material affect uncertainty or, as now more precisely defined, joint product ambiguity. It is further shown that access to star talent and attractive material is affected by the production-distribution contracting form. Hence, scarce resources such

8 As for instance how product uncertainty affects distribution performance uncertainty, and both affect channel uncertainty (see Section 7.2.1).
as these seem to be highly relevant for the causal relationships between contracting and the specific investments established above.

It is not an aim and beyond the scope of this study to integrate resource-based theories into TCE or vice versa (Argyres & Mayer, 2007; Mayer & Salomon, 2006), so resources are strictly discussed in a TCE context. In this context, the focus is primarily on how transactors anticipate resource dependencies and organize with respect to them (Williamson, 1996).

By adding resources as an additional intermediate variable and drawing on the findings presented in Section 7.2 above, two additional relationships may be proposed (see Figure 8.4 below):

Figure 8.4 - TCE relationships between specific investments, joint product ambiguity, resources and contracting form identified in this study (established relationships marked with dashed arrows)

The first relationship is between resources and joint product ambiguity:

(8.3) Joint product ambiguity is dependent on the resources dedicated to the product, and more resources reduce the joint product ambiguity.

As shown in the case of star talent this may be a dynamic process, whereby the resource reduce product uncertainty (less uncertainty about the form of the product) and performance uncertainty (less uncertainty about the quality
of activities carried out in one or more transactions required to create the joint product, which again reduces channel uncertainty (less uncertainty about the ability to conclude all transactions required to complete the joint product).

Since a reduction in joint product ambiguity will encourage specific investments, adding resources offers an indirect means for encouraging specific investments. The relationship between resources and specific investments is illustrated in the Box 7.2 mini-case, in which an investor seeks out and ties its investments to specific resources (stars), thus providing the joint product transactors (producer and distributor) acquiring any of these resources access to specific investments.

Furthermore, a pattern emerged which showed that these scarce resources were in higher demand for projects requiring more specific investments (i.e. higher-budget movies requiring substantial investments with high specificity). These investments have a higher loss significance, which may be sought to be offset by a lower loss likelihood to keep the overall risk lower. Adding resources (attractive material and star talent) reduces joint product ambiguity and thus the perceived loss likelihood. More generally therefore, one would expect to see a higher demand for resources for specific investments with a high loss significance, which implies that the demand is also sensitive to the transactor’s risk preferences.

The second relationship is between contracting and resources:

(8.4) The transactors’ ability to attract resources is dependent on the contracting form used between them; more integrated contracting increases the transactors’ ability to attract resources.

In this study, it is found that more integrated contracting has a positive effect on a transactor’s (producer’s) reputation in that those providing scarce resources (e.g. talent agencies) typically perceive it as being more able to conclude the transaction (see Sections 7.2.2 and 7.2.3). In some cases, typically for the most attractive resources, less integrated contracting may in fact preclude access to the resource. If transactors anticipate a dependency on such resources to reduce joint product ambiguity to an acceptable level for any specific investments required, they may need to use integrated contracting for their transaction.
However, the importance of reputation, and thus relational contracting (Carson et al., 2006), in the causality of this relationship means that integrated contracting between transactors may not always be necessary for either to obtain attractive resources since a positive reputation may have other sources (see for instance the case of George in Section 7.2.2). On the relationship between formal and relational contracting, the data support both the view that these may be complements (as in Michael’s case in Section 7.2.2)(Poppo & Zenger, 2002) and the view that these may be substitutes (as in George’s case) (Dyer & Singh, 1998; Uzzi, 1997). However, there is no indication in the data that formal contracting should undermine relational contracting (Ghoshal & Moran, 1996). Hence, for more reliable tests of the effect of contracting on resources, reputation may be added as an intermediate variable. Furthermore, continuity (or frequency) may have a similar effect to that of reputation. No such pattern emerges in this study, but since reputation and continuity are the key factors in the calculative approaches to relational contracting, one may expect similar effects here as well. The sanctions in both cases loom under the “shadow of the future” in the form of a loss of future business (Carson et al., 2006; Poppo & Zenger, 2002; Poppo, Zhou, & Ryu, 2008).

It follows from the above that in the causal relationship between contracting and specific investments, resources are akin to contractual commitments in their ability to reduce joint product ambiguity and thus attract specific investments. A contractual joint value creation commitment from one transactor (e.g. a distributor committing to a minimum width of the theatrical release) reduces joint product ambiguity much in the same way as acquiring a resource (e.g. the services of star talent). Or in the case of a transactor with internalized resources (e.g. a talent-owned and controlled production company), the result may essentially be the same (the talent/owner committing to personally participating in the project rather than hiring another talent of similar standing). However, since access to resources is also dependent on contracting form, it is more likely that resources will augment the effects of contracting on joint product ambiguity than that it will provide a substitute to contracting as a means to reduce such ambiguity.
8.2 How Contracting Affects Specific Investments due to Coordination

The second intermediate variable identified in the relationship between contracting and specific investments is coordination. In the core TCE framework, coordination is a means of cooperative adaptation by transaction parties to disturbances to avoid the cost of maladaptation, which Williamson (1991, 1996) traces back to Barnard (1938). It is the conscious, deliberate and purposeful efforts to craft adaptive internal coordination mechanisms, the “marvel of internal organization” (Williamson, 1991). It offers an alternative to the other type of adaptation, which is the autonomous kind in which transaction parties each adapt without any cooperative efforts. Instead, each is independently relying primarily on the price mechanism to guide its adaptation to avoid the cost of maladaptation. This is the “marvel of the market,” which Williamson (1991) traces back to Hayek (1945).

The benefits of coordination come at the costs of added bureaucracy and reduced incentive intensity, so at the outset it will have a disadvantage relative to autonomous adaptation. However, as bilateral dependency between transactors increases with asset specificity, coordinated adaptation will be preferred by transactors over autonomous adaptation. This is the basis upon which Williamson (1991) proposes his discriminating alignment of market, hybrid or hierarchy as the governance structure with different levels of asset specificity. Hence, the concept of coordination and its relationship to specific investments are at the core of TCE theory.

Also, a slightly different and in this context less relevant type of coordination costs associated with internal organization have been identified and emphasized by other TCE scholars (Demsetz, 1988; Masten et al., 1991), which relate to the costs of organizing resources within firm boundaries. These are sometimes also referred to as organization or management costs.

Yet, the coordination issues emerging from the data in this study are somewhat different from those initially emphasized by Williamson. As a means of adaptation to disturbances, coordination as described by Williamson is primarily associated with volatility types of uncertainty for which it offers transactors efficient realignment preventing opportunistic behavior. The coordination issues identified here are less about adaption to a
volatile environment, but more about inherent coordination needs between the numerous micro-level transactions embedded in the transactors’ joint value creation. The type of coordination issues emphasized by Williamson is primarily related to ex post transaction cost efficiencies and the ex ante anticipation of these (i.e. contractual or hierarchical safeguards against maladaptation), while those identified here are more directly associated with production cost or value creation efficiencies. Mesquita and Brush (2008) introduce the label production coordination for this latter type, which they define as “the handling of the organizational complexity inherent in decomposing production tasks and managing their interdependent parts across firms” (p. 785). This is more closely related to Thompson’s (1967) approach to coordination, which again was based on March and Simon (1958). If the emphasis on production tasks is replaced with micro-level transactions, it serves as a fairly precise definition of the coordination issues identified here.

Production coordination may not be the most prominent type of coordination scrutinized in the empirical TCE literature, but it is grounded in TCE theory as a means offered by more integrated governance structures to economize on production costs. Instead of a tradeoff between the costs of coordination (governance) mechanisms and minimizing the ex post transaction costs of maladaptation, the relevant tradeoff here is between the costs of coordination mechanisms and the potential gain of production economies. Also, this may all be considered transaction costs since foregoing production economies benefits may be defined as an ex ante transaction cost (see Section 3.4). Criticism of TCE for ignoring this type of coordination (White & Lui, 2005) is based on the same false assumption as the criticism of TCE for ignoring value creation issues (Zajac & Olsen, 1993), namely that TCE ignores production economies and only focuses on transaction cost efficiencies.

The findings presented in Section 7.3 show that more integrated contracting provides transactors with mechanisms to better coordinate their respective micro-level transactions required to complete their joint product. Upstream, certain packaging transactions are difficult or impossible to effectuate for the producer without more integrated types of contracting with a distributor since: a) the suppliers (stars, agents, etc.) may require financial commitments that the producer cannot solely provide, and b) suppliers may require certain value sharing arrangements that cannot be completed without the distributor’s consent. Downstream, certain exploitation transactions are
difficult or impossible to effectuate for the distributor without more integrated types of contracting with the producer since: a) suppliers (toy manufacturers and other types of licensees) may require a long production lead time for their products, and b) suppliers may require adjustments to the joint product that the distributor cannot satisfy alone (e.g. the inclusion of a brand in the movie). In addition, distribution executives report of better production efficiency for distribution transactions when being able to draw on the coordination mechanisms provided by more vertically integrated contracting (e.g. in creative advertising and publicity). More horizontally integrated contracting allowed for a better production coordination between distribution transactions across market channels.

Hence, the first proposition on production coordination:

(8.5) Production coordination is dependent on contracting, and more integrated contracting gives transactors: a) better production coordination and b) better production efficiency.

The impact of frequency and continuity should also be noted here. Among the low frequency (acquisition) transactions, the more integrated types of contracting (pre-sale) offer better production coordination since the contract is in place prior to the joint value creation establishing routines and rules for communication and decision-making between the parties. However, higher frequency (output) transactions offer yet better production coordination because in addition to the coordination mechanisms offered by the contract, the transactors benefit from inter-organizational learning effects that increases the coordination efficiency (see Jennifer’s comments in Section 7.3.3, p. 274). The data indicate that continuity under relational contracting has a similar effect. The output of these learning effects may be seen as additional specific assets of the human kind that enhance governance economies (lower coordination costs), in addition to production economies.

The findings further show that certain specific investments are dependent on production coordination. If certain upstream packaging transactions cannot be sufficiently coordinated, they will not be effectuated and these specific investments (into star talent and material type of resources) will be foregone. Similarly, if certain downstream exploitation transactions cannot be supported with sufficient production coordination mechanisms, they will not
be carried out and these specific investments are also lost. Hence, a second proposition:

(8.6) Specific investments are dependent on production coordination, and better production coordination will allow for increased specific investments.

The effect of production coordination on specific investments rests on the complexity of the transaction in which the specific investment is made (e.g. packaging, publicity and exploitation transactions). The degree of complexity can vary substantially from a simple market type packaging transaction in which a script is purchased for a flat fee, to intricate talent transactions involving pay and play commitments, approval and control rights, value sharing arrangements and possibly also the bundling of resources (as in Johnny’s case, Section 5.3.2). Without complexity contracting providing coordination, mechanisms do not yield benefits beyond those without such mechanisms (Macher & Richman, 2008; Mesquita & Brush, 2008), so adding greater coordination to simple transactions has little or no effect on specific investments. Hence, a minimum level of complexity is assumed in proposition (8.6) above, and generally, complexity functions as a moderating variable in this relationship:

(8.7) Complexity moderates the effect of production coordination on specific investments; greater complexity increases the positive effect of production coordination on specific investments.

In Section 7.3, it was shown that the demand for production coordination and the impact of such coordination on investments was particularly high for bigger budget movies. This follows from these projects, which typically contain and require the more complex production and distribution transactions. In addition to the complex packaging and exploitation transactions discussed above, these movies may for instance also require complex licensing agreements with commitments from exhibitors prior to greenlight, and thus a rigid timeframe for the joint product creation (see Section 5.4.1 and Box 5.6). Lower budgeted movies will typically contain simpler types of production and distribution transactions, and the specific investments required will therefore be less sensitive to the lesser production coordination mechanisms offered by non-integrated types of contracting.

The relationships between contracting, production coordination, complexity and specific investments are summarized in Figure 8.5 below (production
efficiency is excluded from the figure because the data does not provide evidence of a relationship between efficiency and specific investments).

Figure 8.5 - TCE relationships between contracting form, production coordination, complexity and specific investments identified in this study

8.3 How Contracting Affects Specific Investments due to Spillovers

In Section 7.4 above, it is shown that in the presence of positive forward spillover effects from the primary theatrical market to ancillary markets more horizontally integrated contracting encourages specific investments into the joint product. The subject of spillovers and externalities has received relatively little attention in the TCE literature, possibly because when it does it tends to be in expressly inter-transaction contexts (Kang et al., 2009; Mayer, 2006; Nickerson & Silverman, 2003). It is also typically defined in this context, as for instance by Mayer (2006), who defines it as “benefits or costs that accrue to one or both of the parties to a transaction that go beyond the scope of the transaction” (p. 69). However, as shown in this study, an intra-transaction perspective is also relevant because one may have spillovers between the micro-level transactions carried out within the scope of the focal transaction. When a distributor under a production-distribution contract benefits from marketing spillovers between licensing transactions for various market channels, this is an example of such intra-transaction spillovers. The domestic marketing investment is an investment into a specific asset that yields scale economies, thereby providing the foundation for scope economies among market channels. As a common input of this type into the marketing in several channels, it creates the circumstances for which Teece (1980) argues that horizontally integrated structures are likely to be efficient modes of organization.
In the positive reverse relationship between contracting and specific investments identified in Section 7.4 *spillovers* is not an intermediate variable, but an underlying variable. The presence of the underlying variable is a condition under which an independent variable has a certain effect on the dependent variable. Changes in contracting form do not affect spillovers, but the presence of spillovers causes variation in the contracting form to affect specific investments. Since there are positive forward spillovers from domestic theatrical distribution investments into performance in foreign markets, distributors are willing to invest more aggressively when the horizontal dimension of the production-distribution agreement allows them to control more foreign markets and thus benefit from these positive spillovers. Hence, contracting is not used to create positive spillovers, but may be designed for a transactor to *capture* such spillovers. The positive spillovers are inherent in the nature of the transactions. The positive forward spillovers from the primary market channel to ancillary channels identified here create economies of scope and scale that encourages higher specific investments when captured and internalized through horizontally integrated contracting.

It was further shown that when split rights contracting is utilized, foreign distributors put a great emphasis on domestic distribution commitments if considering a pre-sale acquisition for its territory. This is partly because such commitments reduce joint product ambiguity, as discussed above, but also because these foreign distributors capture and benefit from spillovers created by such domestic commitments.

Based on these findings the following proposition is made (see Figure 8.6 below):

(8.8) *In the presence of positive spillovers: (a) contracting forms that integrate these spillover effects with a transactor encourage this transactor to increase its specific investments (b).*

![Figure 8.6 - TCE relationships between positive spillovers, contracting and specific investments identified in this study](image)

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The spillovers identified in this study are directly related to the joint product, which in previous chapters has been labeled as a movie’s image (see Table 1.1). Of the spillover types discussed in the literature, it is most similar to brand spillovers. Hennig-Thurau et al. (2009) have studied brand spillovers for movies, seeking to measure the financial value of their brand’s extension rights (e.g. the sequel rights to a movie), hence considering the joint product of the initial movie as a brand.

In view of the findings made here it is interesting to note that Kang et al. (2009) also find spillovers to affect specific investments. They use inter-transaction spillovers to partially explain the phenomenon of unilateral specific investments in asymmetric transaction relationships (with dominant buyers). While they investigate knowledge and reputation spillovers, which are derived from creating the joint product rather than directly related to it, their argument is that transactors are more likely to make unilateral specific investments when the investment yields sufficient economic values for other transactions with the same or other transaction partners. Essentially, this is the same economies of scope and scale argument as presented above, namely that positive spillovers create scope and/or scale economies, thus increasing return on investment and justifying higher specific investments.

8.4 From the Perspective of Interdependence

A bigger picture emerging from the empirical relationships between contracting, empirical intermediate variables and specific investments summarized in Figure 7.15 is that there is a significant level of interdependencies inherent in the production-distribution transaction. However, beyond the critical recognition that specific investments create bilateral dependency between transactors, the subject of interdependence as such is not prominent in the TCE literature. It has received more attention in the alliance literature (Aggarwal, Siggelkow, & Singh, 2011; Gulati, Lawrence, & Puranam, 2005; Gulati & Singh, 1998), in which insights from the TCE literature have been supplemented with organization design theory (Barnard, 1938; Galbraith, 1977; Thompson, 1967). The alliance approach is easily related to the context of this study, as the output types of contracting may be said to represent alliances between producers and distributors. As a

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9 Williamson (1999) has however identified greater attention to technological and contractual nonseparabilities as a research opportunity in the further development of TCE.
concept, interdependence partly captures the relationships discussed in the previous sections of this chapter, which suggest that it also deserves closer scrutiny in the present TCE context.

Not surprisingly, given that asset specificity creates greater transactor interdependence and TCE prescribes integrated contracting to govern transactions requiring specific investments, the alliance literature on interdependence predicts that the greater the anticipated interdependence in an alliance, the more hierarchical the governance structure used to organize it (Gulati & Singh, 1998). The parallel to TCE is apparent: Whereas the alliance literature shows that greater interdependence creates coordination costs (a particular type of transaction costs) that are most efficiently handled in more integrated governance structures, the TCE literature shows that greater asset specificity creates transaction costs that are most efficiently handled in more integrated forms of governance.

To measure the degree of interdependence, Gulati and Singh (1998) suggest using Thompson’s (1967) distinction between pooled, sequential and reciprocal interdependence. Pooled interdependence describes situations in which the parties pool their resources to achieve a shared goal, the common benefits arise from combining resources into the shared pool and each partner uses resources from this pool. Adjusted to the present context, emphasizing transactions rather than activities, sequential interdependence describes situations in which the parties are serially arrayed so that the micro-level transactions carried out by one partner precede those of another, resulting in a higher degree of coordination than in pooled interdependence. Finally, reciprocal interdependence describes situations in which the parties’ micro-level transactions are carried out simultaneously. Each party is therefore simultaneously dependent on the other because its outputs are the other’s input.

Thompson’s classification of interdependence provides an interesting perspective to the contracting forms studied here. Essentially, the interdependence between producer and distributor in acquisition type transactions may be described as sequential, while it is better described as reciprocal in output type of transactions. Hence, the different degree of interdependence is not only a matter of the inherent qualities of the transaction and its requirements in terms of; a) adjusting joint product ambiguity, b) allowing production coordination, and c) internalizing
spillover effects, but also a matter of how the transaction is carried out as a consequence of the chosen contracting form. The degree of interdependence may therefore both affect contracting and specific investments and be dependent on the same two factors.

A hypothetical example based on the data and findings drawn from it above may illustrate the dual role of interdependence. Assume at the outset that a certain movie may be produced and distributed either under split rights acquisition contracting or under an all rights output deal. Under the acquisition transaction producer and distributor would be sequentially interdependent since production transactions would be carried out prior to distribution transactions. However, producer and distributor would only make the specific investments considered acceptable to each under conditions of unbalanced joint product ambiguity, limited production coordination and with positive spillovers divided between third-party foreign distributors. Given the ensuing level of upstream and downstream specific investments, one may turn around and argue that governance structures supporting sequential interdependence are sufficient in this case. Now, if one alternatively would decide to produce and distribute the same movie under output contracting, the producer and distributor would be reciprocally interdependent, as certain production transactions (e.g. talent packaging) would be dependent on the distributor’s micro-level transactions and certain distribution transactions (e.g. exploitation) would be dependent on the producer’s micro-level transactions. However, with a balanced joint product ambiguity, better production coordination and internalized positive spillover effects, each party would be likely to make higher specific investments. Considering these increased specific investments, one may now turn around and argue that only governance structures supporting reciprocal interdependence are sufficient. Hence, dependent on the choice of governance structure, the joint product will in fact not be the same movie. Under acquisition contracting, it is more likely to resemble the typical “independent movie” made on a lower budget, with less star talent and more modest marketing, while the output contracting version is more likely to resemble the typical “studio movie” made on a higher budget, with more star talent, heavier marketing and a wide release.

Since the choice of governance structure affects the nature of the joint value creation, one may also say that it changes the value creation logic. In the example above, the production and distribution transactions carried out
under the acquisition contracting option contain all the traits of Thompson’s (1967) long-linked technology, while the resemblance is closer to intensive technology under the output contracting option. Similarly, the value configuration (Stabell & Fjeldstad, 1998) shifts from an almost pure system of value chains toward a value shop when moving from acquisition to output contracting.

It follows that contracting, specific investments and interdependence ultimately need to be aligned with the type of joint value creation the transactors envision. Projects requiring substantially specific investments entail a high degree of interdependence that only more integrated forms of contracting can efficiently satisfy. Hence, without more integrated forms of contracting, the required specific investments should not be made. Projects with lower requirements for specific investments entail a lower degree of interdependence, thereby allowing for less integrated forms of contracting. These lower levels of specific investments may thus be achieved with less integrated contracting.

Based on the above, the following is proposed (see Figure 8.7 below):

(8.9) In the presence of a stronger interdependence between transactors (a) more integrated contracting forms encourage the transactors to increase their specific investments (b). However, the degree of interdependence is affected by the amount of specific investments (c) and all three elements must therefore be aligned with the joint value creation sought by the transactors.

Figure 8.7 - The relationships between interdependence, contracting and specific investments identified in this study
8.5 Summary of Contracting Form’s Effects on Specific Investments

For the cases studied here, the data reveal that contracting does indeed affect specific investments, and in this chapter a number of more general propositions are made based on these findings.

For the horizontal contracting dimension, an effect on specific investments is observed in the presence of positive spillovers. More horizontally integrated forms of contracting allow a transactor to internalize these spillovers, thereby creating economies of scope and scale that justify higher specific investments to be made (see Figure 8.6 above). Similar effects based on spillovers are not identified for vertical contracting.

Primarily for the vertical contracting dimension, but also to a lesser degree for horizontal contracting, the effect on specific investments is caused by two intermediate variables, as shown in Figure 8.8 below. First, more integrated contracting balances the joint product ambiguity between the various specific investments to be made by the transactors, and may thereby reduce the risk for certain investments from otherwise prohibitive levels. In the data studied here, this effect is particularly important for upstream specific investments. Also, while not included in Figure 8.8, the effects of resources augment this relationship.

Second, more integrated contracting provides better production coordination, and the more complex micro-level transactions require more production coordination for either transactor to carry them out. Hence, without contracting providing a sufficient level of production coordination, some micro-level transactions cannot be effectuated, and specific investments into these, as part of the overall joint value creation, are then foregone.

Finally, the interdependence construct captures many features of the above relationships and thus seems highly relevant to understanding the effects of contracting on specific investments. For transactors seeking to create joint value requiring higher specific investments, higher interdependence will be a product of the fundamental transformation that entails these investments. The interdependence may, among other factors, include both requirements for production coordination and joint product ambiguity adjustments, and more integrated types of contracting will be required to facilitate such requirements. Hence, transactors may strategically choose the type of
contracting aligned with the level of specific investments, and therefore the degree of interdependence, associated with the sought joint value creation.

*Figure 8.8 - Summary of the relationships between contracting and specific investments identified in this study (excluding spillover effects which were only identified for horizontal contracting)*
9 Concluding Remarks and Reflections

This final chapter discusses broader theoretical and methodological implications for the proposed transaction value model and TCE theory in general. First, I return to the TCE-based transaction value model proposed in Chapter 3 and discuss the implications of the conclusions about governance structure’s effects on specific investments drawn in the previous chapter. I then move on to a subject that emerged from derivative findings observed throughout the research process, namely the theoretical and methodological significance of framing TCE’s unit of analysis. I close with a discussion of the study’s limitations, suggestions for further research, an outline of some key implications for practice and policy and a few final remarks.

9.1 Implications for a TCE-Based Joint Value Approach

In Chapter 3 a model is suggested for a fuller-form transaction value analysis that goes beyond the reduced-form analysis’ concern with governance structure alignment (Williamson, 1991), which instead focuses on the ultimate goal of maximizing transaction value (Figure 3.2). The model shows how the minimizing of governance costs, with which the reduced-form analysis is primarily concerned, needs to be considered in a tradeoff with production economies if the objective is to maximize transaction value.

I also argue in Chapter 3 that the production economies component of the model is not separate from the transaction cost analysis. Rather, it is integrated into the transaction cost analysis since potential losses of production economies due to inferior structural choices are in fact ex ante transaction costs.

The production economies are heavily dependent on transaction-specific investments since specific assets generally provide enhanced productivity and value creation (Bensaou & Anderson, 1999; Williamson, 1985). Transaction-specific investments thus affect both governance economies (directly and through governance structure) and production economies, but with opposite effects. While they have a positive effect on production economies improving productivity and value creation, they generally have a negative effect on governance economies adding transaction costs. Transaction-specific investments are therefore crucial to the tradeoff between governance and production economies, and this renders specific
investments, if possible, an even more significant construct in the fuller-form analysis than in the reduced-form analysis.

It is well established by the empirical TCE literature that asset specificity and governance structure correlate, but in this dyadic relationship specific investments have almost entirely received an exogenous treatment (David & Han, 2004; Macher & Richman, 2008; Rindfleisch & Heide, 1997). Our understanding of the origins of transaction-specific investments has thus been underdeveloped. This is exposed in the analysis provided in Chapter 3, in which I only assume that more integrated structures induce specific investments. The assumption is based on TCE theory and the established empirical correlation, but on this basis only the directionality lacks empirical grounding and the causal explanation is sketchy at best. Since it is this very analysis that uncovers and concludes with the said key tradeoff between governance and production economies, the full transaction value model rests on this assumption. Consequently, the express objective of this study has been to investigate exactly how structure affects specific investments so that the assumption may be replaced with empirically grounded knowledge.

The microanalytic empirical analysis of specific investments and production-distribution contracting in the motion picture industry presented in the foregoing chapters supports the assumed basic relationship. But in addition to providing empirical grounding for its directionality, the causality is explained in great empirically grounded detail. And interestingly, the causality identified here is quite different from what was assumed based on previous theory. A more integrated structure’s superior ability to offer safeguards for specific investments was assumed to explain the causality, but as summarized in the previous chapter other factors emerged from the data: First, uncertainty was shown to play a significant role in that more integrated structures offer greater ability to balance joint product ambiguity (a specific type of uncertainty), which again induces specific investments. Hence, while not explicitly shown in the model, this key TCE construct is also central in any transaction value analysis because of its role in the relationship between structure and specific investments. Second, the presence of positive inter-transaction spillovers is important since more integrated structures allow transactors to internalize these, which also induces specific investments. This is a variable that has been largely ignored in the TCE literature despite some notable advances (Kang et al., 2009; Mayer, 2006). Finally, but not least important, interdependence and coordination emerged as playing central
roles in the relationship between structure and specific investments. Specific investments are interdependent to a varying degree and the more interdependent can only be undertaken within structures that provide the required level of coordination. These latter findings are closely related to the bundled approach to analyzing transactions taken here (see next section), in which the focal transaction is seen in the context of the relevant micro- and/or macro-level transactions carried out by each transactor. This is a departure from TCE’s traditionally strict focus on single transactions. For interdependence and coordination, which have previously received limited attention in the TCE literature, it meant drawing primarily on Thompson’s (1967) organizational theory and adapting his use of the constructs to a TCE context. The result is primarily expanding the discussion of these constructs from one governance structure, the internal organization of a firm (hierarchy), to a broader range of structures on the continuum from market to hierarchy.

If these findings are valid outside their current context of the motion picture industry, uncertainty, spillovers, interdependence and coordination all become important variables in any joint value analysis as intermediate and underlying variables in the relationship between governance structure and specific investments. A detailed knowledge of the relationships and interplays between these variables, as identified in Chapter 8, is therefore also essential from the perspective of the overall transaction value model.

Figure 9.1 - Contributions to a TCE-based transaction value model
The contributions made by this study are emphasized in Figure 9.1 above. The dashed arrows represent relationships also included in reduced-form analysis, while the solid arrows represent the path of relationships added to obtain a fuller-form transaction value analysis. Beyond this conceptual contribution, the study has made a number of contributions in empirically grounding, explaining and validating the relationship between governance structure and transaction-specific investments (marked with a thicker solid arrow). This is the first relationship in the production economies path to transaction value, and without empirical grounding and causal explanation, the relationship would have remained assumed only and hence left the model on feet of clay.

9.2 Contextualizing the Unit of Analysis

TCE’s unit of analysis is the transaction and the theory is thus inherently microanalytic in its approach. When analyzing larger systems, e.g. in Williamson’s (1985) treatment of a firm’s efficient boundaries, chains of activities such as a firm’s value chain are unbundled so that one transaction may be analyzed at a time. However, while such analyses are illuminating and beneficial, Williamson (1999b, 2010) also calls for a reverse bundling process, arguing that the neglect of both technological and contractual nonseparabilities leads to incorrectly specified transactions, and that the practice of examining transactions as if they were independent will not do if there are significant interaction effects between them. He identifies such approaches beyond piecemeal analysis as a key research opportunity in the further development of TCE.

Argyres and Liebeskind (1999) take a dynamic view and argue that a transactor may be bound by the governance structure applied to other transactions in which it is already engaged, and they refer to this condition as governance inseparability. This incorporation of history into transaction cost theory does not, however, inform the type of transaction contextualization on which this study’s analysis rests.

The analyses in the present study have been entirely dependent on a bundled approach to the transaction in which it is scrutinized in the context of related transactions. The key contextualization is not vertical but horizontal (or hierarchical), defining layers of transactions where the focal transaction defines the relevant vertical chain of micro-level transactions.
Contextualizing the focal transaction in a macro level may also prove useful, as the production-distribution transaction is contextualized here from the perspective of a project. The approach is shown schematically in Figure 9.2 below, and here a second micro-layer is also included for illustrative purposes. In the present study, the second micro-layer would have represented a transaction between suppliers and subcontractors (e.g. between an editing facility hired by the producer and suppliers of editing equipment), but this layer was excluded from the analyses since the data did not indicate that these transactions had much impact on the focal transaction.

An important choice and distinction is made by focusing on transactions rather than activities. These are sometimes mixed in discussions of transactions between activities, and interesting attempts have been made in incorporating these into a common unit of analysis (Nickerson et al., 2001). However, when focusing on activities rather than transactions in a TCE context, the opportunity to gain insight from the fundamental analysis of transactions’ dimensions is lost. If this study’s focal transaction had been analyzed as one between production and distribution activities rather than one between production and distribution micro-level transactions, important insight gained (in Chapter 5) about asset specificity and uncertainty grounded at this micro level is likely to have been neglected.

The impact of this form of contextualization is clearly illustrated in the identification of asset specificity and interdependence. First, for asset specificity the aim is to determine the degree of specificity for investments required by the focal transaction partners, and it is demonstrated that only considering specificity in the context of the focal layer does not produce
sufficient insight. In this study, the dominant cause of specificity was found in the macro layer: Once production and distribution investments are made into a project they become largely unsalvageable outside the context of the project, and this is referred to as project-specific investments. In the focal layer, the key determinant of specificity is if a production investment is made into a movie that requires a wide theatrical release or only a more modest release since this significantly affects the degree of small number bargaining facing the producer when seeking distribution. For any single investment, there may thus be a fundamental transformation process associated with each layer, and the degree of specificity is determined by the cumulative effect of these. Second, the degree of interdependence in a focal transaction is largely determined by the nature of the micro-level transactions included in the bundle. It is shown here that exploitation transactions (a type of distribution micro-level transaction) greatly influence the degree of interdependence in a production-distribution transaction. The modest attention given to interdependencies in the TCE literature may be explained by its typical focus on single transactions, rather than on contextualized focal transactions.

Sometimes the focal transaction may also itself be layered, as shown in Section 6.4, and this represents the most basic type of layered contextualization to be observed. Seen as a whole, a transaction of this type is not necessarily governed by a discrete governance structure, but by a package of structures that may include various forms (e.g. a production studio acquiring movies from independent producers to feed its output deal with a major studio). Similar types of layered focal transactions have also been recognized when MNEs gradually internalize foreign operators (Petersen et al., 2010). Failing to recognize the layered inter-transactional contextualization of the type illustrated in Figure 9.2 limits insight, but cannot be said to misrepresent the focal transaction. However, failing to recognize intra-transactional layering of a focal transaction may result in analyzing a fraction rather than a complete transaction, and this may be a case of what Williamson (1999b) refers to as incorrectly specifying transactions as a result of context ignorance.

Since the inter-transactional type of contextualization discussed here is primarily horizontal, the focal transaction will define a layered bundle of transactions to be analyzed in order to obtain insight into the focal transaction (those within the dashed square in Figure 9.2). As foreseen by
Williamson (1999b), this entails certain practical challenges, as it requires a deeper knowledge of how a system actually works and a sensitivity to subtle but lurking strategic features. While qualitative approaches like that of this study are well equipped to meet such challenges, it is more difficult to see how quantitative approaches would be able to identify the relevant layered bundles of transactions. Quantitative studies of layered bundles may therefore be limited to those contexts for which a deep knowledge of the system already exists.

9.3 Limitations of the Study

There are a number of limitations to this study that will benefit from a brief discussion. Most of these follow as a result of the chosen research design and method, and the first is a result of choices made throughout the process due to a limited capacity for both data collection and analysis. On the macro-layer, the data analysis is primarily limited to single projects, thereby limiting insights into the possible impacts of frequency at this layer (the plural perspective discussed in Section 4.4). For multi-project contracting (output contracts), the focus here is more on each separate project within the context of a multi-project contract and less on interaction effects between these projects. The data do for instance suggest that there are learning effects generating human asset specificity related to frequency and continuity that affect the efficiency of production coordination (reported in Section 7.3), and that there are vertical spillover effects between projects (e.g. between franchised movies, see Box 6.20). These relationships were only cursorily explored here and further enquiries may (and may not) have revealed relationships between frequency, vertical spillovers and specific investments.

A choice was also made to quite strictly focus on TCE and its constructs. This follows the express research objective of elaborating on TCE theory to better understand the effects of contracting on specific investments. The flip side is that this approach may limit the overall understanding of certain phenomena. Applying theoretical triangulation by for instance also drawing on the resource-based view (RBV) of strategy (Barney, 1991; Wernerfelt, 1984) in the discussion of how resources affect the relationship between contracting and joint product ambiguity (in Section 8.1.2) might have strengthened the understanding of resources in this particular context. Similarly, a deeper investigation of the learning effects generating human asset specificity discussed above could also have been seen within an
integrative perspective on the TCE and RBV approaches to strategy and as such represented a contribution to the recent research on how governance leads to the development of capabilities (Mayer, Somaya, & Williamson, 2012). But, again, the primary objective was not to understand these particular phenomena, and to the extent such triangulation could have improved the understanding of the effects of contracting on specific investments, it would have been a different kind of theory extension (drawing on and possibly merging with neighboring theories) than what was sought here.

This study’s relatively tight research design of focusing on the key established TCE constructs, as well as the use of semi-structured interviews, may have caused certain other origins of specific investments to go unexplored, which a more loosely designed study might have captured. Therefore, this study should not be seen as having unraveled the origins of specific investments (in the motion picture industry). That would be an overstatement. However, to reduce the risk of ignoring possibly important factors, all interviewees were asked to suggest topics relevant to the study objective. Also the depth (and length – some lasting two hours) of the interviews reduces this risk. The inclusion of some very rich documentation (monographs written about specific movie projects, production companies, release seasons, etc.) in the data had a similar effect. And, again, the objective was to focus on the constructs already established in the TCE literature.

Finally, a note should be made about the generalizability or external validity of the research results. One should be careful to generalize any result from a case study unless the study is designed specifically for this purpose (Andersen, 1997), but given the design and case definitions used here one should be able to apply the results to relevant situations within the motion picture industry (but also see the note on further motion picture industry research in the next section). As discussed in Section 4.4, national contexts differ so care should be taken, particularly if applying results to the motion picture sectors in less market-driven and more culturally embedded and controlled environments. To what degree the results may be applied in any other or wider context greatly depends on the attributes of these contexts. The theory extension made in this study relies on contracting, specific investment, joint product ambiguity and other constructs of the types observed in the motion picture industry. It may therefore be more difficult to
apply the findings to other contexts in which these attributes differ (e.g. a high volatility rather than a high ambiguity context) or where the value configuration system differs (i.e. value shop or value network types rather than the value chain type) (Stabell & Fjeldstad, 1998). However, the findings made here should be relevant for other value chain types of industries in which: (a) production involves customized projects, thus resulting in substantial specific investments of the product type; (b) there is a significant degree of joint product ambiguity; and (c) a variety of contractual relationships are used to govern joint value creation and claiming.

9.4 Suggestions for Further Research

Since this study is concerned with the further development of TCE theory towards a transaction value approach by enhancing our understanding of how governance structure affects specific investments, further research based on the theoretical implications set out in Chapter 8 is of course desired. Within the context of the motion picture industry, further research may draw on this study for understanding the inter-transactional contextualized system, which opens up for quantitative tests of the proposed theoretical relationships. Accessing quantitative data may be a challenge (see Section 4.1), but data on production investments and resources may be accessed from publicly available sources (such as IMDbPro). Following the categorization of contracting developed in Chapter 6, one may be able to trace and categorize a sufficiently large sample of contracts based on trade journals’ reports and overviews (such as Variety’s annual “Facts on Pacts”), thus overcoming the obstacle of gaining access to actual contracts. For other variables one may need to settle for proxies, such as for instance theatrical release width as a proxy for distribution investments.

Further studies outside the context of the motion picture industry would be particularly welcome, as supportive evidence from such studies would also increase the external validity of the propositions made here. When designing such studies, the focus should be on analytic generalization (Yin, 2009), and a replication of this study within a context in which the developed theory would predict the same results is recommended. Other creative industries with high levels of ambiguity, and where cooperative joint value creation requiring significant to substantial specific investments are carried out through a variety of contracting forms, are interesting candidates (gaming, music, etc.).
The discussions of uncertainty in Chapter 8 (and in previous chapters) reveal problems of subcategorizing various types of the construct. This problem is also reported in recent TCE review articles (David & Han, 2004; Macher & Richman, 2008). As this study has revealed, different types of uncertainty have different effects in the relationship between contracting and specific investments. It is thus unsatisfactory that the key subcategories provided by theory (behavioral and environmental) do not capture the empirically grounded differences. Similarly, it has also been found that different types of uncertainty may have opposite influences on governance structure (Klein, 1989).10 TCE seems to have a construct validity problem related to the uncertainty construct, and given its centrality in the theory a further development of the construct is called for.

A further suggestion is concerning the relationship between the transaction as TCE’s unit of analysis and the transactor as the strategy decision maker. It is observed on several occasions throughout the data analysis that there may be significant discrepancies between what each transactor may see as an ideal form of contracting. The possibly clearest example is in the different preferences for acquisitions and pre-sale acquisitions between distributors and producers, respectively (see Section 6.2.1). Since the more integrated contracting form balances joint product ambiguity, it will be preferred by the transactor responsible for upstream specific investments, the producer, which at the outset faces the highest degree of ambiguity. The transactor responsible for downstream specific investments, the distributor, faces a lower ambiguity and will hence seek to avoid such balancing by utilizing the lesser integrated contracting form. The ultimate outcome in choice of contracting form will depend on various factors, which may somewhat vaguely be captured in the concept of each transactor’s ex ante bargaining strength. In these situations, each transactor will face a tradeoff between the transaction costs associated with adapting the other party’s contracting preferences on the one hand and the opportunity cost of a forgone transaction and value creation on the other.

TCE’s strength lies in analyzing and understanding transactions, and when a focal transactor is chosen it can strategically advise with regard to

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10 Klein (1989) makes a distinction between uncertainty related to turbulence (including complexity and volatility) and uncertainty related to unpredictability (including new technologies and volume), and finds that the first is related to more integrated governance structures, while the latter is associated with market-like governance structures.
governance structure, and as shown in this study, specific investments, which are decisive for both joint value creation and claiming (Ghosh & John, 1999). However, the tools to predict outcomes when interests are conflicting, as illustrated in the example above, seem underdeveloped and as such this offers an interesting area for further TCE research.

Finally, the transaction value model is widely adaptable beyond strategic management and media economics. As illustrated in Macher and Richman’s (2008) review, the applications of TCE are indeed covering a wide range of social sciences, and the model would apply to any value creation problem that can be formulated in terms of contracting. These may also emerge from related constructs not included in the model itself. The model would for instance predict that in a context in which the institutional environment does not support or allow integrated governance structures, specific investments would suffer with diminishing overall value creation as a likely consequence. And this prediction may be applied just as widely as to anti-trust regulation on the one hand and bans on gay marriage on the other. The possibilities for further research based on the proposed transaction value model are therefore abundant.

**9.5 Implications for Practice and Policy**

As the external validity of my findings outside the motion picture industry is yet untested, the focus here is on practice and policy implications for this industry. These are also relevant for media economy scholars.

For industry professionals, numerous implications follow from the results presented and discussed in Chapters 7 and 8. Strategic advice on any specific area covered can also be read quite directly out of these findings, as for instance in relation to how production-distribution contracting may be used to attract star talent to a project or how star talent may substitute for distribution contracting when seeking production finance. Most important, however, is adapting a joint product view on motion picture production and distribution (see Table 1.1). Focusing solely on production, as is quite commonly done by both practitioners and media economists, does not capture the value creation relevant for understanding performance and return on investments. Production is better understood as one of two components required for the complete product, and it is this perspective that brings the production-distribution transaction and contracting to center stage.
In general, the results uncovered in this study suggest an awareness of the interdependency between contracting and specific investments. For this reason, professionals should be careful not to assume that positive or negative contracting experiences from movies with one type of requirement for production and distribution investments can be applied to other types of movie projects. Also, contracting is not only a result of the type of movie one seeks to realize, but may also be used strategically in the process to realize the project. Aligning the appropriate type of contracting with the investment and resource requirements of a proposed project will induce access to both. And the flip side is that while a contracting form may be used contrary to the predictions made here this increases the likelihood of maladaptation with sub-optimal joint value creation and sharing as a result.

In the context of the previous media economic research suggesting a positive relationship between investments and performance (see Section 2.1.2), the results of this study would imply that significant attention should be paid to the strategic use of contracting and structure. If greater project-specific investments improve performance (ceteris paribus), applying contracting that encourage such investments may provide a significant strategic advantage.

Following from the above, policy makers should be careful to consider the contracting implications of their policies for motion picture producers and distributors. Certain policies intended to support value creation may also have significant but less palpable reverse effects if they directly or indirectly entail structural limitations on integrated forms of contracting. Again, at a very basic level, such consideration is dependent on policy makers’ recognition of the joint product and joint value approaches to value creation in the motion picture industry. The key to meeting challenges identified in the production sector may lie in the distributors’ institutional environment, and if so, making policy adjustments here may be more effective than attempts to target the production sector directly.

9.6 Final Remarks

Two key arguments are made in this dissertation, where the second follows from the first:
1) By integrating transaction cost implications of production economies into its analytical framework, TCE may shift attention from governance alignment to transaction value; and

2) Both governance structure and transaction-specific investments require endogenous treatment.

A conceptual model for transaction value analysis is proposed, and since the model rests on the effects of governance structure on transaction specific investments that were heretofore only assumed, the empirical work has focused on this particular relationship.

For readers of TCE literature, the finding that structure affects specific investments is hardly surprising given the correlation between the two established by the empirical literature on the reverse relationship (David & Han, 2004; Macher & Richman, 2008; Rindfleisch & Heide, 1997). The causality of how exactly structure affects specific investments is hopefully regarded as more noteworthy.

It is shown here how the strategic use of structure to reduce uncertainty, and thus the risk associated with specific investments, induces the transactors to make such investments in their joint product. Furthermore, it is not the behavioral uncertainty with which much of the TCE literature has been preoccupied (Klein et al., 1978; Williamson, 1975, 1985) that emerges as most important in this context, but rather the ambiguity associated with the joint product. It is also shown how internalized or contracted scarce resources may have similar effects on uncertainty and thus on inducing specific investments, but also how these resources may depend on structure.

Coordination, which is embedded in the TCE theory but typically less explicitly investigated, also emerges as a key factor in understanding the causality. So do interdependencies and spillovers.

By identifying these variables and key causal relationships between them, all embedded in a broader transaction value model, this study provides a basis for expanding the TCE literature’s attention from governance alignment to transaction value.
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