Negotiating Electronic Publishing Agreements

By Mark Litwak

The terms of the producer-distributor agreement are critical.

Many producers of multimedia programs do not distribute their own works. They enter into agreements with publishers and/or distributors. The arrangements vary greatly depending on how the parties want to share the financial risks and rewards of creating and selling the program, and how they divide marketing and distribution responsibilities.

For purposes of this discussion, a publisher packages the product, conceives a marketing strategy, creates a marketing campaign and materials, determines the optimal suggested retail price, and arranges for distribution of the product. A distributor warehouses the product and ships it to retailers. Companies may perform more than one function. The publisher takes the risk of the product not selling since retailers usually have 100 percent return privileges. Essentially the retailer is taking the product on consignment. If it doesn't sell quickly, it may be returned to the publisher.

This article describes and analyzes the key provisions that an attorney negotiating a publishing deal for a producer needs to be concerned with. Whether you have negotiated a number of these deals or are preparing your first, the discussion contained herein should prove helpful to your practice.

Conflict of Interest

When a publishing company develops some of its own products, it may favor those products developed in-house over those acquired outside. Outside developers should be aware of this inherent conflict of interest, which may become pronounced if the internally developed product is more profitable to the publisher than the outside-acquired product. A developer should not enter into an agreement with a publisher who is primarily motivated by a desire to fill out a product pipeline and amortize marketing costs.

The contract can state that the publisher will use its "best efforts" to market the product. Alternatively, the publisher could agree to promote the program on a no-less-favorable basis than its other programs, or it could agree to spend minimum monies to advertise and promote the product. If the latter course is chosen, the agreement must carefully define advertising and marketing expenses to exclude the publisher's general overhead expenses, such as legal fees and office rent. It is best to limit advertising expenses to direct out-of-pocket expenditures made to promote the particular product.

If a large advance against royalties can be obtained, the publisher will aggressively sell the product. If a large advance cannot be secured, a provision for minimum royalty payments is a good alternative.

Grant of Rights

The developer of a program can license limited rights to the program to a publisher or he or she can assign (transfer) all rights to the program. If the program is a custom-made program, the company that commissions it will usually insist on copyright ownership. In this case, the developer may only be entitled to receive a fee for creating the program. Agreeing to forego copyright ownership may not be a significant concession if the program is so specialized that there is no outside market for it.

Developers who use their own resources to create a program, do not want to sell all rights to one publisher. Rights granted can be limited in time, by platform, or by geography. Some publishers simply do not have the ability to market the product in all platforms, media, and territories. A developer may be willing to grant a publisher the right to distribute by CD-ROM and computer disks, but reserve game cartridge and all other rights, including the right to distribute over online networks. Publishers usually want a broad grant of rights. Because the marketplace is still developing, they want the right to distribute the program on new platforms that may be developed.

Related Rights. Merchandising and book publishing rights should also be considered. Products spun off from a popular video game, such as toys based on a character, could generate substantial revenue. The right to make a sequel is another potential source of income. If the publisher helps make the program a hit, it will want to continue to reap the rewards by publishing sequels. The developer, on the other hand, may want to reserve these rights or give the publisher only a right of last refusal that would grant the publisher the right to match the best offer made by a third party.

Exclusivity. Publishers will usually insist on an exclusive agreement for whatever markets and media are covered. Otherwise, there could be a great deal of confusion among retailers and consumers as to the identity of the programming. Moreover, publishers will want developers to agree not to develop any products that are directly competitive. Distributors, on the other hand, may be willing to accept products on a non-exclusive basis, and may be willing to distribute similar products by different publishers.

Limitations. The developer can grant only those rights that he or she possesses. If the multimedia program incorporates a software engine or a component borrowed from another program, the developer may only have the right to use it on a one-time basis in his or her own program. The developer, in this instance, cannot assign a copyright to those components because he or she does not own the copyright; he or she has only a limited license to use the programming.

Reserved Rights

If the developer wants to use portions of the work in future work, that right should be reserved. For instance, the developer may want to use characters created for one program in a future program. Or, the developer may want to reuse certain development tools, routines, and other underlying technology in a future program. When a developer reserves the right to use portions of a program again, the publisher will receive non-exclusive rights to those portions of the program.

Compensation

Compensation is typically in the form of royalties, often with an advance payment made to the developer. The advance counts against the royalties earned. If the advance is non-refundable, as is common, the developer will not have to repay it, even if the royalties earned never cover the amount of the advance.

Sometimes a developer wants an advance payable before completion of the program because the money is needed to create or finish the program. A publisher is unlikely to give such an advance unless it is fairly confident the developer can deliver the final product. If such an advance is given, it will be refundable in the event the developer fails to deliver the program.

Although the size of the royalty is important, the manner in which it is calculated is critical. A royalty could be based on gross revenues with no deductions for the publisher's marketing and shipping costs. More likely, the royalty will be based on net revenues (or net receipts), where certain costs are deductible from gross revenues, and what is left, if anything, is the base on which the royalty is paid.

Net Revenue Royalty. Publishers prefer a royalty based on net revenues because they want to be able to deduct some expenses before sharing revenue with the developer. They will argue that it is not fair to ask them to pay royalties before they recoup their manufacturing and shipping expenses.

Developers are concerned that publishers will deduct so many expenses, some of questionable merit, that no payment will be due. In the movie business, studios have a history of "creative accounting." Their distribution agreements define "net profits" in such a manner that the studio is allowed to deduct substantial distribution fees, overhead, and interest. As a result, profit participants rarely receive any profits.[1]

In multimedia publishing, royalties are typically based on "net revenue" or "net receipts," not "net profits." "Net revenue" is defined so that taxes, freight, discounts, returns and co-op ads are deductible but no deduction is allowed for distribution fees or overhead. The definition may, or may not, allow a deduction for manufacturing costs. Because deductions are limited, a multimedia producer sharing "net revenues," is much more likely to receive money than a movie producer sharing "net profits."[2]

A publisher can expect to receive from resellers, such as distributors, wholesalers, and retailers, about 40 to 50 percent of the retail price. Thus, a program selling for $100 retail might return $50 to the publisher. After deductions for discounts, returns, and other allowable expenses, net revenue may amount to $40 per product. If the developer is entitled to a 10 percent royalty, the developer will get $4.00 per product sold. If the developer received a $40,000 advance, royalties from the first 10,000 sales will be retained by the publisher to recoup the advance.[3] Note that revenue may decline if the publisher discounts the product to spur sales or reduce old inventory. Keep in mind that the typical retail price for CD-ROMs today is considerably less than $100 per unit, and prices are expected to decline further.

Fixed Royalty. The parties might agree to a fixed royalty; that is, royalty that is a fixed sum, perhaps payable in installments. The developer, for example, could be paid $40,000, payable in four $10,000 installments. Here the developer is guaranteed a fixed amount regardless of how many units the publisher sells. Publishers who are willing to pay a fixed royalty take the risk of paying the royalty despite poor sales. They also stand to retain a larger share of revenue if the product is a hit because the royalty does not grow as sales increase.

Publishers will want to set fixed royalties low. Developers may be unhappy with a modest fixed royalty because they will not share in its "upside" potential. A better solution, from the developer's point of view, may be a substantial advance payment against royalties. The advance amount is a guaranteed set amount that applies against a royalty on sales. This way, the developer is assured of receiving the advance and can share in revenues from a hit product.

Royalties are often from 5 percent to 20 percent of net receipts, with most deals falling in the 10 to 15 percent range. Royalties can be payable according to a sliding scale, with the percentage changing as sales increase. For example, a 10 percent royalty might be payable on the first 10,000 copies sold, with a 15 percent royalty thereafter. A different royalty could apply to direct sales through mail-order catalogs and for foreign sales.

Worldwide Rights. If the publisher has worldwide rights, it may sub-license publishing rights to foreign publishers. Thus, an American publisher may arrange for a Japanese publisher to market and distribute the product in Japan. In such a deal, the Japanese distributor may bear all the costs of translating and marketing the product in Japan. There is little risk to the American publisher, and the royalty payments received by the American publisher are almost pure profits since the American publisher does not bear the cost of the foreign marketing. In such a case, a developer is justified in seeking a larger share of foreign royalty payments.

Bundling Deals

If the product is "bundled," calculation of net revenue may become problematic. When a program is bundled, sales may increase dramatically since the software is being sold in volume with another product. The publisher, however, will likely receive a smaller payment for each copy sold. Moreover, several of the publisher's products may be bundled with a third-party's hardware. Allocation of revenue among the programs may be difficult. Sometimes a publisher may want to give away a product as a premium or to build market share. This strategy may be wise for the publisher but may not be in the interest of the developer. The publishing agreement should address how the developer will be paid for bundling deals. Often, the developer will simply receive a fixed dollar amount per copy, rather than a royalty.

Audits and Accounting

The agreement should provide for the monthly, quarterly, or semi-annual payment of royalties with an accompanying accounting statement. The developer should have a reasonable length of time to challenge statements. A developer will not want to incur the expense of an audit until he or she is reasonably certain the audit will pay for itself. Because revenue may dribble in over an extended period, developers should not be forced to either audit early or waive their rights. The agreement may provide for reimbursement of audit costs and attorney fees if the developer successfully recovers as a result of accounting errors. If the publisher maintains several offices, make sure to specify that the audit can take place at a convenient office.

Reserves for Returns. The agreement may permit the publisher to establish a reserve for returns. This allows a publisher to withhold some of the royalty due the developer to account for possible returns. The publisher will argue that it should not have to pay a timely royalty on all copies sold because some of these copies may be returned and refunds issued. The reserve for returns should fall within a range of 10 to 25 percent of sales.

Interest and Security

Late payments due the developer should be subject to an interest charge. The higher the interest rate, the less incentive there is for the publisher to delay payment.

A developer can also request a security interest in any distribution agreements, and the monetary proceeds from those contracts, which the publisher makes with distributors. This may give the developer preference over unsecured creditors in the event a publisher goes bankrupt. Security interests in copyrightable works should be recorded with the Copyright Office at the Library of Congress in Washington, D.C. A security interest in a work or a distribution contract cannot be recorded until the work itself is registered with the Copyright Office. Use a Document Cover Sheet to record the security interest. In addition, the security interest should be registered under state law in any state where the publisher has an office. Registration is accomplished by filing under the Uniform Commercial Code, Form UCC-1.

Warranties and Indemnification

A publisher will want the developer to warrant that he or she has good and complete title to the property or rights that he or she is licensing, that the property does not infringe on anyone else's rights (including rights of defamation, invasion of privacy, right of publicity, trademark, and copyright), and that there are no claims or litigation outstanding in regard to the property.

Absolute Warranties. The publisher will prefer absolute warranties. Under such a warranty, if the developer's promise is broken, the developer will be liable, notwithstanding any excuses he or she may have. The fact that the developer made a promise under a good faith, but mistaken, belief does not relieve him or her of liability. Thus, if a developer honestly believed that his program did not infringe anyone's copyright because he thought a film clip included in the program was in the public domain, and he was mistaken, he will be liable for copyright infringement and for breaching his warranty to the publisher. The publisher can then seek to have the developer reimburse it for the expense of defending against a lawsuit and any court judgment.

Good Faith Belief Warranties. A lesser warranty is one based "to the best of one's knowledge and belief." Under this warranty, if the promisor has a good faith belief that its work does not infringe the rights of others, it will not be liable for breaching its warranty, even if the work does infringe another's work. If the publisher objects to such a warranty, the developer can argue that E & O insurance is available to protect against potential liability, and the insurance carrier's assets are more substantial than the developer's. If the publisher insists on an absolute warranty, a developer should try to limit it to matters about which the developer has first-hand knowledge.

Delivery Requirements

The agreement will specify when a fully-functional copy of the program must be delivered to the publisher. Delivery will usually be on floppy diskettes in object code. Developers may want to retain source code (human-readable code), delivering only object code (machine readable code) to the publisher. With access to source code, the publisher can more easily create its own version of the program. Consequently, most developers guard their source codes carefully.

A newly written computer program is likely to contain some errors or bugs. Upon completion, the program will undergo Alpha testing which is usually done by professional testers employed by the developer or publisher. Next is beta testing, or live environment testing, where test copies are given to users to test the program outside the laboratory in a real-life context. When a product successfully completes testing, the publisher will usually certify in writing that the product appears to meet its performance requirements.

The developer may nevertheless have a continuing obligation to fix any bugs that surface later and promptly deliver a corrected version. If the developer does not supply a corrected version in a timely fashion, the publisher may have the right to prepare a corrected version and charge the developer for the expense. The agreement could provide that the developer will fix any bugs gratis for six months after delivery. After that, the publisher may be required to pay the developer for time and materials to fix any bugs or enhance the program.

Technical Support for End Users

Either the developer or publisher must provide for end-user technical support. This may be a considerable and continuing expense that should not be undertaken lightly. A developer will have a more intimate knowledge of its product than the publisher, and thus is in a better position to answer technical inquiries. When the publisher agrees to provide technical support, the developer may be expected to help train the publisher's personnel and to consult with the publisher to resolve technical problems.

Upgrades

New versions, or upgrades of the program, are important because software products can quickly become obsolete. Upgrades may be done by the developer or publisher. If the developer has the responsibility for doing the upgrade, the publisher may be required to pay the developer a non-refundable advance against royalties. The contract should specify how many lines of code are required for each upgrade and when the upgrades need to be done. The obligation to do an upgrade may be tied to time (e.g. once a year) or amount of sales (e.g., if less than 10,000 units are sold in a quarter).

If the publisher takes responsibility for preparing upgrades, the developer's royalties may be scaled back as future versions are released. A reduced royalty may be reasonable because at some point a subsequent version may contain little or no code from the developer's original program.

Trademarks

The name of a program may become a valuable trademark. Sequel products may rely on this brand-name to help the public identify a product. Publishers often insist on owning the trademarks to the programs they sell. The publisher will want to own all rights to advertising and promotional materials as well.

Confidentiality

Both parties may want to protect various trade secrets, technology, financial information, and marketing plans from disclosure to outsiders. Particular care must be taken to protect information or technology that is unprotectable under copyright or patent law.

Termination

Developers should attempt to negotiate termination clauses in their publishing agreements. Such a provision can permit the developer to terminate a contract if the publisher is in breach. The provision may allow the developer to recover all money due him or her as well as regain all rights to his or her program. The publisher will want to limit grounds for termination to a "material" breach, and will want notice and time to cure any default before the developer can terminate the agreement.

Arbitration

Arbitration is usually preferable to litigation. This is especially the case when the other party is better able to finance a protracted court struggle. An arbitration clause should provide that the prevailing party is entitled to reimbursement for costs and reasonable attorneys' fees.

Mark Litwak is an entertainment and multimedia attorney with Berton & Donaldson in Beverly Hills, California. He is the author of four books and is currently writing "Litwak's Multimedia Producer's Handbook" which will be published in 1996.

[1]In book publishing, on the other hand, royalties are typically based on a percentage of retail price.

[2]If the publisher is permitted to deduct packaging, marketing, and/or trade show expenses, the developer should try to cap the maximum allowable expenses.

[3]It may take more than 10,000 copies shipped to recoup the advance because the publisher may not be obliged to pay a royalty on product given for promotional purposes or to secure shelf space.

SOFTWARE PUBLISHING AGREEMENT CHECKLIST

By Mark Litwak

Parties:
Developer:
Publisher:

Entities: Individual, partnership, corporation?

Due Diligence: Is publisher reputable?
Does publisher handle this type of product?
Track record of publisher:

Grant of Rights: Ownership of copyright:

License: Exclusive or non-exclusive:

Term:

Platforms:
CD-Rom:
Game cartridge:
Online:

Territories:

Ancillary Rights:
Merchandising:
Book publishing:
Sequel program:
Right of last refusal:

Reserved Rights:
Right to use portions of work in other products:
Right of first negotiation:
Right of last refusal:

Compensation:
Advance:
Non-recoupable:
Against royalties:
Minimum royalty payments:
Guarantee:
Right to terminate if shortfall:
Royalties:
Percent of net revenues:
Amounts paid:
Amounts invoiced:
Deductions allowed: taxes, freight, discounts, returns, co-op ads.
Deductions not allowed: distribution fee, overhead.
Negotiable deduction: cost of manufacturing.
Fixed royalty:
Time of payment:
Installments:

Sliding scale royalties:
___ percent of first _____ copies sold
___ percent of next ____ copies sold
___ percent thereafter.
Royalty on sub-licenses:

Conflicts of Interest: Conflicts with other products.

Clauses:
Best efforts clause:
Favored nation's clause:

Minimum Advertising & Promotion:
Limited to direct out of pocket costs?

Bundling Deals: Fixed dollar amount per copy.

Accounting: Monthly, quarterly, yearly?

Audit Rights:
Location:
Time limit:
Reimbursement of audit fees if underpayment.

Reserve for Returns: (10 to 25 percent)

Interest on Late Payments:

Delivery Requirements:
Object code only:
Date for delivery:
Developer continuing obligation for testing and correction:

Technical Support of End Users:
Publisher:
Developer: direct to end user or consult with publisher.

Warranties:
Absolute:
Best of knowledge and belief:
E & O Insurance: developer named insured.

Security Interest:
Termination clause:
For breach:
For shortfall:
Arbitration:
Venue:
Forum:
Reimbursement of attorney fees:
Choice of law: