

Net Profits Deals: The Recording Industry's New Contract Du Jour

by Bob Donnelly

As an attorney for recording artists, I have seen many new waves of music come and go during the past thirty years. These trends occasionally beget a new form of legal agreement. For example, the popularity of hip-hop music spawned the decidedly anti-artist "production agreement." And the digital revolution has led to the development of new agreements for telephonic "ring-tones." The new contract du jour is the so-called "net profits" deal. This is the one where artists are told that their band and the record company will "split everything 50/50." These deals are typically the province of the small "indie" labels that seem to be growing at warp speed as the "majors" continue to merge themselves out of existence. Just a few years ago, I would only rarely come across this type of deal (usually from a good small label like Kill Rock Stars). Today I would estimate that "net profits" deals represent approximately one-quarter of all the new indie labels deals that I negotiate.

Whether or not "net profits" deals are as "artist-friendly" as advertised deserves closer scrutiny. In a conventional record deal, the record company pays for the following costs on a *non-recoupable basis*: manufacturing, warehousing, shipping, advertising, distribution, marketing, promotion and publicity. (Generally, if any of the last three services are provided by non-record company independents, 50% of those costs may be recouped out of the artists' share of royalties.) In a "net profits" deal, the record company recoups all of these costs "off the top" (i.e., out of the first monies received from the sale of CD's). Even the band's roadie can understand that so far, this "artist friendly" agreement may not be so "artist friendly."

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The rationale of indie record companies for why artists should happily embrace a recoupment formula that is worse than that offered by the majors (who thought that was possible?) is based on the eventual 50/50 split of profits. (The operative word here is "eventual.") When one closely analyzes these deals, one often discovers that they are only 50/50 when it serves the record company's interest.

An Indie Band/Indie Label Hypothetical

Consider the following illustration. The deal process usually begins when an indie band (let's call them "The Self-Deceivers") delivers a fully-mixed master recording which they produced at the band's own expense. Even if the artists use some home recording equipment and Pro-Tools technology, it is likely that they will have invested approximately \$25,000 into the production of their album. In a typical "net profits" deal, artists will receive a nominal advance that is less than the amount they had previously invested in recording costs. For example, assume that The Self-Deceivers receive a \$10,000 advance from their indie label ("Artie Fufkin Records"). The net result penalizes the band twice. To begin with: The Self-Deceivers are already out-of-pocket \$15,000, because unlike the record company which gets to take *all* of its costs "off-the-top," artists do not! Second, the \$10,000 payment which the band received was in the form of an "advance" which means it must be recouped solely out of the band's share of "net profits." (Does this sound like a 50/50 deal to you so far?)

Upon closer scrutiny of the "net-profits" contract, you will probably find that Artie Fufkin Records has also awarded itself certain other advantages. For example, it is not uncommon for a record company to take a deduction in the form of an "administration fee" or "marketing fee," nor is it uncommon for a record company to simply pay the artist on less than 100% of all records sold. (Assume that Fufkin has decided to pay itself an "administrative fee" of 15% of all gross earnings.)

Another example of creative record company accounting practices is to consider money paid out in the form of mechanical royalties to be an advance solely against the artist's share of the royalties. (Not all indies

do this, but many do.) This is another example of how these “net-profit” deals are actually worse than a conventional record deal, because mechanicals are not usually considered to be a recoupable expense in a conventional deal.

After listening to my explanation as to why this deal is not equitable for my client, indie label president Artie Fufkin (who formed his own record company after Spinal Tap’s “Tap Into America” Tour) would probably argue: “But the artist will still be better off because I’m splitting the net-profits with them on an equal basis.” Let’s crunch some numbers to see if this is true.

For the purpose of this hypothetical, assume that the cost of manufacturing a CD with color booklet and jewel box is eighty cents (\$.80) per unit. Assume also that Fufkin is spending \$1.50 per unit on marketing, advertising, promotion and publicity. As discussed, The Self-Deceivers received a \$10,000 advance and are being paid seventy (\$.70) cents per unit in mechanical royalties, assuming a three-quarter of statutory rate on eleven compositions. (God forbid that the record company would actually pay their “partner” the full 100% statutory mechanical rate.) Finally, assume that Artie Fufkin Records was charging a wholesale price of \$11.00 per unit from which it actually netted \$8.25 after deducting a distribution fee of 25%. (Naturally, wholesale prices and distribution fees can vary, so these numbers are simply intended to be typical of many indie deals.) Let’s see how much money each of the “50/50 partners” in this deal will realize if the first Self-Deceivers album sells 30,000 units (which is a respectable number by indie standards):

**“Net Profits Deal”
(assuming sales of 30,000 units)**

Gross Receipts

30,000	units
<u>x\$8.25</u>	per unit (\$11 wholesale - 25% distribution)
\$247,500	gross receipts

Costs Recoupable “Off-the-Top”

30,000	units
<u>x\$0.80</u>	per unit for manufacturing
\$24,000	manufacturing costs
30,000	units
<u>x\$1.50</u>	per unit for marketing/promotion/etc.
\$45,000	marketing/promotion costs
\$24,000	manufacturing
<u>\$45,000</u>	marketing/promotion/etc.
\$69,000	total recoupable “off-the-top”

Costs Recoupable Solely Against Artists’ 50% Share of Net Profits

30,000	units
<u>x\$0.70</u>	per unit for mechanicals
\$21,000	mechanical royalties
\$10,000	advance
\$21,000	mechanical royalties
<u>\$10,000</u>	advance
\$31,000	total recoupable against artists’ share

Computation of Net Receipts

\$247,500	gross receipts
<u>x 15%</u>	record label’s “administration fee” %
\$37,125	record label’s administration fee
\$247,500	gross receipts
- \$37,125	record label’s administration fee
<u>- \$69,000</u>	off-the-top costs
\$141,375	net receipts

Computation of Artists’ Net Profits

\$141,375	net receipts
<u>x 50%</u>	artists’ % of net profits
\$70,688	artists’ share of net profits before costs
<u>- 31,000</u>	costs recoupable against artists’ share
\$39,688	artists’ share of net profits

Computation of Record Label’s Net Profits

\$141,375	net receipts
<u>x 50%</u>	record label’s % of net profits
\$70,688	label’s share of net profits before costs
<u>+ 37,125</u>	label’s 15% administration fee
\$107,813	label’s share of net profits

Division of Net Profits

\$31,000	mechanicals and advance paid to artists
<u>\$39,688</u>	artists’ share of net profits
\$70,688	total amount of artists’ share
<i>versus</i>	
\$107,813	label’s share of net profits

If you also factor in the additional \$15,000 that it cost The Self-Deceivers to make this album (for which the artist received neither a reimbursement nor a credit against gross receipts as Fufkin did for every dollar it spent), the artists wind up with a net gain of less than

\$56,000 on 30,000 units sold. (This figure *assumes* the artists do *not* have to share mechanical royalties with third party songwriters or music publishers; if they do have to share mechanicals, it would further diminish their net gain.)

This hypothetical also assumes that Fufkin is using a third party distribution company, which is usually the case for indie labels. However, if Fufkin is handling its own distribution in this “net-profits” arrangement, the record company adds another \$82,500 to the money it will receive. In that case, this “50/50” deal looks like this: record company’s share: \$190,300; artists’ share: less than \$56,000.

Now let’s compare this to the conventional record label deal where artists are paid on a royalty basis. We will assume the same number of units sold (30,000 units) at the same net wholesale price (\$8.25/unit), the same artist advance (\$10,000) and the same mechanical royalty rate (\$.70/unit). The Self-Deceivers will be paid an artist royalty of \$1.40 per unit (which is typical of what artists might net after the artists’ royalty rate is applied against a retail selling price of \$17 less a 25%, the packaging deduction and a 15% free goods deduction). In this scenario, the artists will receive only their royalties and will not share in any eventual net profits.

**“Conventional Record Deal”
(assuming sales of 30,000 units)**

Gross Receipts

30,000	units sold
<u>x \$8.25</u>	per unit (\$11 wholesale - 25% distribution)
\$247,500	

Artists’ Royalties

30,000	units
<u>x 15%</u>	free goods deduction %
4,500	free goods
30,000	units sold
<u>- 4,500</u>	free goods
25,500	units royalty-bearing units
25,500	units
<u>x \$1.40</u>	per unit record royalty
\$35,700	record royalties
25,500	units
<u>x \$0.70</u>	per unit mechanical royalty
\$17,850	mechanical royalties
\$35,700	record royalties
<u>\$17,850</u>	mechanical royalties
\$53,550	total artists’ royalties

Costs Recoupable Against Artists’ Royalties

\$10,000 artists’ advance

Net Amount Received by Artists

\$53,550	total artists’ royalties
<u>- 10,000</u>	artists’ advance
\$43,550	net royalties received by artists

Costs Payable by Record Company from Gross Receipts

30,000	units
<u>x \$0.80</u>	per unit (manufacturing)
\$24,000	manufacturing costs
30,000	units
<u>x \$1.50</u>	per unit (marketing/promotional/ etc.)
\$45,000	market/promotional costs
\$53,550	paid to artists (advance + royalties)

Amount Retained by Record Label

\$247,500	gross receipts
- \$24,000	manufacturing costs
- \$45,000	market/promotional costs
<u>- \$53,550</u>	paid to artists (advance + royalties)
\$124,950	amount retained by record label

Division of Net Profits

\$53,550	total amount of artists’ share
<i>versus</i>	
\$124,950	label’s share of net profits

So let us recap: In the so-called “artist friendly” net profits partnership-type arrangement, the artists will net a total of less than \$56,000 that includes all advances, record royalties and mechanical royalties. In the conventional record deal (that we have all learned to loathe and fear), the artists’ all-in receipts will be approximately \$54,000 which is only \$2,000 less than the net profits deal.

When confronted with this evidence Artie Fufkin is now likely to argue: “Okay, maybe it’s not more profitable at 30,000 units, but wait until they sell platinum; that’s when this net profits deal will really pay off big time for the artists!”

It’s important to examine this claim since Fufkin’s point-of-view represents a common myth surrounding these net profits deals. Let’s examine this proposition using the above-described paradigm based upon sales of one million units.

In the conventional record deal, The Self-Deceivers would receive the same \$10,000 advance in addition to

\$700,000 in mechanicals and \$1,190,000 in record royalties (i.e., \$1.40 per unit x 1 million units less a 15% free goods deduction) for a total of \$1,900,000 if their album reaches the platinum sales plateau. (The previously stated artists' record royalties would be reduced by any amounts spent by the label on tour support and 50% of any amounts spent on independent promotion.)

In the net profits calculation, we will assume that marketing costs, which are traditionally front-end loaded, will be reduced and amortized from \$1.50 per unit to \$1.00 per unit based upon sales of 1 million units. I will also assume that Fufkin Records was able to get a more favorable manufacturing price (sixty cents per unit versus the eighty cents per unit which they paid on smaller manufacturing runs). As a result the calculation would look like the following:

**“Net Profits Deal”
(assuming sales of 1 million units)**

Gross Receipts

1,000,000 units
x \$8.25 per unit (\$11 wholesale - 25% distribution)
 \$8,250,000 gross receipts

Costs Recoupable “Off-the-Top”

1,000,000 units
x \$0.60 per unit for manufacturing
 \$600,000 manufacturing costs

1,000,000 units
x \$1.00 per unit for marketing/promotion/etc.
 \$1,000,000 marketing/promotion costs

\$600,000 manufacturing costs
\$1,000,000 marketing/promotion costs
 \$1,600,000 costs recoupable “off-the-top”

Costs Recoupable Solely Against Artist’ 50% Share of Net Profits

1,000,000 units
x \$ 0.70 per unit for mechanicals
 \$ 700,000 mechanical royalties

\$ 10,000 artists’ advance

\$700,000 mechanical royalties
+\$10,000 artists’ advance
 \$710,000 costs recoupable from artists’ share

Computation of Net Receipts

\$8,250,000 gross receipts
x 15% label’s administrative fee %
 \$1,237,500 label’s administrative fee

\$8,250,000 gross receipts
 - 1,237,500 label’s administrative fee
- 1,600,000 costs recoupable “off-the-top”
 \$ 5,412,500 net receipts

Computation of Artists’ Net Profits

\$ 5,412,500 net receipts
x 50% artists’ share %
 \$ 2,706,250 artists’ share before recoupable costs
- 710,000 costs recoupable from artists’ share
 \$ 1,996,250 artists’ share of net profits

Computation of Record Label’s Net Profits

\$ 5,412,500 net receipts
x 50% label’s share %
 \$ 2,706,250 label’s share
+ 1,237,500 label’s administrative fee
 \$3,943,750 record label’s share of net profits

Division of Net Profits

\$ 710,000 mechanicals and advance paid to artists
\$ 1,996,250 artists’ share of net profits
 \$ 2,706,250 total amount of artists’ share

\$ 2,706,250 total amount of artists’ share
versus
 \$3,943,750 record label’s share of net profits

So if The Self Deceivers achieve platinum sales, Fufkin is correct. The band will make more money under the net profits deal (approximately \$2,700,000) than they would under the conventional record deal (approximately \$1,900,000).

Once again this assumes that Fufkin is using a third party distributor. If the record company handled its own distribution, Fufkin adds another \$2,750,000 to its share of revenues. So what does a “50/50” partnership deal look like when the artists sell a million CD’s and the record company handles its own distribution? Like this: record company: \$6,700,000; artists: \$2,700,000.

Admittedly, at this present point in time there is no “standard” music industry net profits deal, but the hypothetical used here is typical of how these deals are often structured. Unfortunately (from the artists’ point of

view), many net profits deals also contain provisions which award the record company an income or ownership interest in the artists' music publishing and/or merchandise rights. If the artists' potential lost income from these categories is factored in, the net profits deal would almost always be an inferior choice (even in the unlikely event that the band sold a million CD's).

It is my hope that this comparative analysis will disabuse artists and their managers and attorneys of the notion that they are always better off by accepting a so-called 50/50 net profits deal. All of which leads me to one very discomfoting notion. I never thought I'd live long enough to regard the 100-page Sony recording contract as "the good old days."