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Initiating Participation Audits In The Motion Picture/Television Industries

by

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When a popular motion picture or television series becomes a hit, but the studio still claims a "net loss," the correct response is to request an audit. However, it may not be enough just to hire an auditor and wait for the report. If a great deal of money is at stake, transactional counsel should be prepared to personally guide the client's claims through the maze of potentially lethal technical defenses that studios build into their standard contracts.

The purpose of the model audit demand letter published with this article is to help the artist's representative avoid those perils and--if need be--to set the stage for litigation when the studio acts in bad faith.

The importance of the audit demand letter is directly related to the contractual statute of limitations contained in almost all studio contracts. This clause reduces to one year the period to file suit over audit claims, and operates in conjunction with the "incontestability" clause, which makes participation statements incontestable if an audit is not conducted within a specified time.

In addition to imposing a time bar on claims, the standard studio contracts also restrict access to audit records covering "incontestable" time periods. Thus, if the picture or TV series approaches break-even after several years and the artist wants to audit going back to inception, the contract language allows the studio to refuse an audit of early reporting periods on the ground that the statements covering those periods have become incontestable.

These interrelated clauses may place the artist in the untenable position of having to audit and sue over hypothetical accounting issues long before money is due--or risk losing the right to challenge the early participation statements. This dilemma is particularly acute in TV, where profitability is rarely even a possibility until syndication, which typically occurs long after the issuance of the first net loss statement.

Are these seemingly onerous provisions enforceable? Contractual statutes of limitations and incontestability clauses are subject to challenge only if the period allowed is unjustifiably short. See, 3 Witkin, *California Procedure*, Actions ' 334: "[Contractual limitations] are generally upheld if the shortened period is reasonable, i.e., if it gives sufficient time for the effective pursuit of the judicial remedy."

Additionally, courts may declare contractual clauses invalid to the extent that the clauses are intended to

exempt a party from its own fraud. Calif. Civil Code ' 1668 states: "All contracts which have for their object, directly or indirectly, to exempt anyone from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of law."

The role of the audit demand letter is to invoke the doctrine whereby a plaintiff may toll the contractual statute of limitations if the aggrieved party does not "discover" misconduct until after the statute of limitations has run.

The so-called "discovery rule" clearly applies to toll the statute of limitations for fraud. See, Calif. Code of Civil Procedure ' 338(d) (Fraud statute of limitations runs from date of discovery.) It is less clear under what circumstances tolling applies to breach of contract claims, although California courts have expressly extended the discovery rule to breach of contract causes of action where the plaintiff did not have the information needed to detect the breach. See, *April Enterprises, Inc. v. KTTV* (1983) 147 Cal.App.3d 805, 832 ("[W]e hold the discovery rule may be applied to [contract] breaches which can be, and are, committed in secret and, moreover, where the harm flowing from those breaches will not be reasonably discoverable by plaintiffs until a future time.")

The importance of using a broadly-framed audit demand letter is best understood by studying the "due diligence" element of the discovery rule. In *April Enterprises, supra*, 147 Cal.App.3d at 833, the court upheld tolling but also stated that "[i]t is plaintiff's burden to establish facts showing that he was not negligent in failing to make the discovery sooner and that he had no actual or presumptive knowledge of facts sufficient to put him on inquiry."

If the model audit demand letter is used and the studio denies access to records, then "due diligence" has clearly been exercised with respect to any later-discovered claims, and the statute of limitations should be tolled. Conversely, a potential time bar arises if records were never requested.

Impact of Cost Restrictions

Likewise, if the studio proffers access to records but the auditor is instructed to limit the audit procedures in order to save the client money (and therefore does not review all of the records made available), the studio will have a strong argument for enforcing the incontestability and contract statute of limitations bars. In either case, the tolling doctrine might not apply, due to a lack of diligence by the profit participant.

Auditors are often instructed to spend \$10,000 or less. That may be adequate in some cases, but a *thorough* audit should cost five to twenty times that much when a film generates \$100 million in revenue. In a litigation context, this author has spent in excess of \$250,000 on audit fees--resulting in the discovery of tens of millions of dollars in concealed claims. The investigation, of course, was aided by a court order.

Because of the fraudulent concealment and discovery rule doctrines, where there is a good possibility of concealed claims, transactional counsel should be very cautious about placing restrictions on the auditors just to save money. If such cost-saving limits are imposed, it should *only* be done with the "informed consent" of the client.

The model audit demand letter accompanying this article is not for use in every case. Rather, it is a maximum demand for records which should be used only when there is a likelihood of substantial, across-the-board underreporting of revenue and overcharging of expenses.

In many cases, an auditor will have advance knowledge of specific claims and will only want to see particular records related to those issues. As noted above, there may also be client-imposed, cost-related restrictions on how much time the auditor can spend. In either situation, the auditor may want to make a narrower, "targeted" audit demand. In those situations, the auditor's professional recommendation to limit the audit demand should normally be adhered to.

Combating Contract Language

However, when enough money is at stake, and a maximum demand is appropriate, the audit demand letter should be used. In response, the studio will usually invoke contract language that expressly restricts the scope of access to records, and assert that the requested audit poses a danger of interfering with "normal business operations."

If arbitrary and unreasonable restrictions are placed on an audit, they undermine the validity of the result. Are such contractually agreed restrictions enforceable?

Where the restraints are designed to prevent discovery of fraud, and especially where they are part of a "contract of adhesion," they are subject to challenge as unconscionable and void against public policy. See, Calif. Civil Code ' 1670.5.

Moreover, if litigation is commenced, courts will frequently ignore contractual audit restrictions and allow much broader access to records under civil discovery procedures. This author has obtained orders to compel the production of millions of pages of studio accounting records, including GAAP corporate ledgers and foreign records in Los Angeles--none of which would have been allowed under the audit rights clause in the original contract.

Convincing a court to issue such an order will be easier if the studio has refused a manifestly reasonable pre-litigation request for access to financial records necessary to conduct an audit in accordance with Generally Accepted Audit Standards ("GAAS"). Even if the studio were allowed to impose such restrictions by the terms of its own contract, the court may interpret the studio's self-determined restrictions as possible evidence of fraudulent concealment. The model audit demand letter is intended to be the first step in creating a "paper trail" for making that kind of proof.

Model Audit Demand Letter

Dear _____:

I represent _____, a participant in the [motion picture] [television series] _____. We have received your participation statement dated _____, reflecting [no money] [a minimal amount] [a surprisingly small amount] due to my client. In light of the well-known success of the [picture] [series], we have serious questions about the poor results reflected on the statement. Accordingly, we have retained the C.P.A. firm of _____ to audit your books and records. They will be in contact with you shortly about scheduling the audit, and we request that you show them every courtesy.

Please provide our auditors with complete access to all books and records of the company pertinent to their audit, including (but not limited to) all work sheets created in the preparation of the participation statements and all foreign and domestic journals, ledgers, calculations, statements, reports, "back up" documentation, and all other documents which would be accessible to the outside auditors of your company operating in accordance with Generally Accepted Audit Standards (GAAS).

At the outset, in order to perform their work, the auditors will require:

(a) A complete listing of itemized expenses charged to the picture in each territory where it has been exploited, stating the amount, identifying the vendor/payee, describing the purpose of the expense, stating the date incurred, stating the date paid, and providing identifying information necessary to locate the back up documentation (purchase order number, check number, invoice number, microfilm coordinates, etc.);

(b) Access to all "back up" documentation for all such expenses, in a form which can be easily correlated to the itemized listing;

(c) A complete listing and itemization of all revenue reported to the picture broken down by territory, licensee,

amount and date of receipt;

(d) Access to ledgers, cash receipt journals, licensee files, microfiche records (including COM), microfilm, CD ROM, computer files, and equivalent records for the domestic territory and the major foreign territories;

(e) Access to all contracts, licenses, output agreements, "side deals," statements, allocations, licensee "accounting files," and all other documents pertinent to a determination whether the correct amount of revenue has been reported; and

(e) Access to the personnel of your company who maintained the company financial records and can therefore answer questions as they arise.

Please confirm, at your earliest convenient opportunity, that the foregoing records and information will be provided to our auditors.

Very truly yours,

Model audit demand letter by **Joseph D. Schleimer, Esq., with Steven Sills, C.P.A., and William Adelman, C.P.A.**

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